R4105-29.81 U
1/89

The Conference Board

HUMAN RESOURCES OUTLOOK 1989

- *labor shortages are spreading*
- *5% wage inflation likely in '89*
- *benefit costs rising faster than wages*
- *growing pressures to lift labor productivity*
- *but no recession in '89*

Research Bulletin No. 227

THE CONFERENCE BOARD'S 1989 HUMAN RESOURCES OUTLOOK

REX D. ADAMS
Vice President, Employee Relations
Mobil Oil Corporation
New York, New York

ALAN R. EWALT
Senior Vice President
National Medical Enterprises
Los Angeles, California

MITCHELL S. FROMSTEIN
President
Manpower, Incorporated
Milwaukee, Wisconsin

DAVID LEWIN
Professor of Business
Columbia University
New York, New York

IRVING MARGOL
Executive Vice President
Management Services Group
Security Pacific National Bank
Los Angeles, California

DANIEL J.B. MITCHELL
Director, Institute of Industrial Relations
University of California
Los Angeles, California

JAMES MOBERG
Executive Vice President, Human Resources
Pacific Telesis Group
San Francisco, California

GENE R. REMOFF
Vice President, Human Resources
ARA Services, Inc.
Philadelphia, Pennsylvania

AUSTIN G. THORNE
Secretary-Treasurer
Canadian Federation of Labour
Ottawa, Ontario, Canada

AUDREY FREEDMAN
Management Counsellor
The Conference Board
New York, New York

The Conference Board's annual meeting of human resources experts took place on November 10, 1988. Panel members discussed the current economic situation, compensation trends, human resources developments, and political events. This process provided the predictions for 1989 reported in Table 1. The views quoted were submitted by the participants in writing before the discussion.

© 1988 The Conference Board, Inc.

THE CONFERENCE BOARD, INC.
845 Third Avenue, New York, N.Y. 10022
THE CONFERENCE BOARD OF CANADA
255 Smyth Road, Ottawa, Ontario, K1H-8M7, Canada
THE CONFERENCE BOARD, INC.
Avenue Louise, 207 Bte 5, B-1050 Brussels, Belgium
THE CONFERENCE BOARD, INC.
1755 Massachusetts Avenue, N.W., Suite 312, Washington, D.C. 20036

Human Resources Outlook, 1989

Audrey Freedman

Overview

Labor shortages and their effects on business were a prime subject of this year's human resources outlook discussion. Six full years of economic recovery have produced the "tightest" labor market in decades. Many industries are operating at top capacity; in the same way, business seems to have reached the edge of the population's capacity to produce additional trained workers. Consequently, employers are staffing their operations with greater difficulty and at rising cost. The signs of wage inflation are beginning to appear in those areas with greatest employment growth. At the same time, intense competitive pressure has made company operations more efficient, pay policies more variable, and employment arrangements more flexible. Employers do not want, and cannot afford, to return to the costly practices they worked so hard to eliminate.

A recession would relieve the current labor shortage and wage pressure—yet The Conference Board's panel expects no recession in 1989. It foresees gradually declining economic growth, with gradually rising inflation in wages, manufacturing labor costs, and ultimately in consumer prices. Specifically, private industry costs for wages and salaries, which rose by 3.7 percent in the year ending September 1988, were predicted to increase 5 percent during 1989 (see Table 1). There will be no relief from the steady inflation of benefit costs, which climbed 6.7 percent in the year ending in September 1988. Union contracts are expected to produce 4.5 percent increases in their first year, roughly on a level with 1988's record. Labor costs per unit of output in manufacturing, a measure of underlying inflationary pressures in the economy, are expected to increase 1 percent, slightly more than their 7/10th percent increase in the year ending September 1988.

Panel members discussed whether or not labor shortages were being experienced by all employers, or were specific to certain areas or occupational categories. In some localities, especially around Boston, there are no

Table 1: Forecasts for 1989 by The Conference Board's Human Resources Outlook Panel

	Median	*Range*
Increase in employer costs for wages & salaries in private industry	5.0%	4.2 to 5.4%
First-year wage and benefit increases in major union contracts	4.5	3.5 to 6.0
Increase in labor costs per unit of output in manufacturing	1.0	-2.0 to 5.5
Rate of inflation (average increase in Consumer Price Index)	5.0	4.5 to 7.0
Unemployment average during 1989		
First quarter	5.2	5.0 to 5.4
Second quarter	5.4	4.8 to 6.0
Third quarter	5.5	4.7 to 6.0
Fourth quarter	5.4	4.6 to 6.0

AUDREY FREEDMAN
Management Counsellor
The Conference Board
New York, New York

workers available "at any price." Recruitment now extends as far as mainland China for those technically trained in such occupations as nursing. Yet when the panel was pressed to limit labor shortages to certain areas, it concluded that lack of qualified workers is a nationwide condition, only more serious in major growth centers.

New legislation affecting human resources probably will not be passed in 1989, primarily because the budget deficit prevents any initiatives requiring federal sponsorship. However, this only increases the pressure to "mandate" human resources programs through employer funding, direct and indirect. The panel expects that, within a few years, Congress will mandate more health benefits coverage, paid through some mechanism that includes employer contributions. Also expected is an increase, in 1989, in the federal minimum wage, probably with a youth subminimum.

This year's panel meeting, more than any previous gathering, focused on social problems. It considered the growing groups of socially and economically unassimilated individuals—people who will not be able to support themselves—or, in many cases, care for themselves. The panel discussed a fragmenting family structure and described islands of non-participants within an economy comfortably living well, if somewhat beyond its means. Mainstream Americans are affluent, fully employed, and optimistic. On the other side of an increasingly higher social divide is an underclass whose position is eroded by drugs, alcohol, homelessness, poverty, and family disintegration.

The following report covers our discussions in more detail.

Labor Shortages

Labor shortages are nationwide, but are usually described in specifics of geographic location and training. Some say that numbers of job applicants are level, but their general qualifications are much lower than a decade ago. Others note that employers were able to select the most highly qualified from among a huge supply of baby-boomers during the middle 1970s.

Even though the U.S. work force is still highly mobile, there exist especially strong labor markets that cannot attract enough workers to fill all openings. This may be partly the result of housing costs and unavailability, or the tendency for families to be far less mobile than individuals. Mitchell Fromstein identified those geographic "hot spots":

MITCHELL S. FROMSTEIN
President
Manpower, Incorporated
Milwaukee, Wisconsin

> "The Atlantic and Pacific coastal regions and the industrial mid-America region are facing the most serious shortfalls, while the Gulf Coast and Southwest regions, still recovering from effects of the oil price crash, have only minor shortages of selected skills. The Wall Street financial district, hard-hit by the October 19 crash (1987), has developed a very short-term surplus of workers at all levels. This condition (Wall Street), however, is quite parochial to the securities industry and has little impact outside of the lower Manhattan area."

Irv Margol identified areas somewhat differently, basing his description on their service industry composition. The only difference of opinion is whether a mid-western manufacturing recovery has produced labor shortages there:

> "Both the Northeast and the West Coast are experiencing very tight labor markets. The Northeast has moved from an industrial-based to a service-based economy. The demand for labor there is predominantly in high-tech and computer-oriented positions plus service-oriented functions.
>
> "The midwest and South are not moving to a service-based economy as quickly. Major industries in these areas have had their problems: drought in farming, disinflation and structural reorganization in business, and competition in heavy

IRVING MARGOL
Executive Vice President
Management Services Group
Security Pacific National Bank
Los Angeles, California

industry. The Southwest has been depressed chiefly due to the decreasing price of oil."

Gene Remoff described labor markets narrowly, as metropolitan areas. He explained the necessity for services to be highly localized and the resulting intensification of labor demand:

GENE R. REMOFF
Vice President, Human Resources
ARA Services, Inc.
Philadelphia, Pennsylvania

"Presently labor shortages vary greatly due to local or regional conditions. With the exception of Texas and Oklahoma, the major metropolitan areas (Boston, Atlanta, North Jersey, Los Angeles, etc.) are the tightest. But other southern cities and their suburbs, such as Greensboro and Richmond are now also tightening as they attract new industry.

"Demographics vary from the national profile not only due to variances in local birth rates 16 to 18 years ago, but by movements of potential labor force members and their parents away from and to what were recognized (by those who moved) as dying or growing economic and cultural centers.

"There is, concurrent with this distribution of labor, too much demand in certain areas. It is now widely recognized that we have a huge services work force. This work force mostly creates and delivers its product immediately in front of and to the customer. It must locate in geographic proximity to its clients and customers (and can not build a 'plant' in Singapore or Puerto Rico to serve meals in Boston, L.A., or northern New Jersey). When an economy booms and goods producers tap the local labor market, the service industries that respond to and support them and their employees also seek to expand. The result is often a compounding of labor shortages.

"Additionally, particularly in suburban and urban areas, new office space is typically created on the assumption that prosperous new tenants with better than average pay and working conditions (these new offices included) will attract a labor pool, in part by tapping into the already employed labor market. Not all employers have been sophisticated enough to determine the availability of needed labor in making new office selections.

"Added to all this, and widely publicized in the general and business press, is the sometimes shrinking and at least not growing body of qualified entrants into the work force from many inner-city school systems."

Jim Moberg described geographic effects in terms of whether or not local employers could count on a flow of immigrants to substitute for declining numbers of young entrants in service jobs:

JAMES MOBERG
Executive Vice President, Human Resources
Pacific Telesis Group
San Francisco, California

"We have seen evidence across the country of the lack of young workers seriously impacting some industries, particularly those where young workers are most frequently employed, such as retail stores and fast food restaurants. This is a true labor shortage affecting those regions where substitute labor is not available.

"The most viable substitute is immigrant labor. Net immigration as a proportion of total population growth has risen to 8.9% since 1975, and will

continue to be a strong new source of labor, contributing to an overall rise in population. The metropolitan areas that attract immigrants, New York and many areas of California, for example, can overcome the shortage in the traditional labor pool by turning to this new group of employees. (More than 52% of the growth rate in California will be due to immigration.)

"Other regions of the country—small cities with smaller economic bases —will find it harder to attract these new workers."

ALAN R. EWALT
Senior Vice President
National Medical Enterprises
Los Angeles, California

David Lewin pointed out that there will be some scarcities of immigrants as well:

DAVID LEWIN
Professor of Business
Columbia University
New York, New York

"The 1986 federal immigration law is aimed at curbing illegal immigration and makes the employer the enforcement agent. While the precise impact of the law remains to be determined, of course, and while forecasters may legitimately disagree over the extent of the law's impact, there can be no doubt that the result of the law will be to reduce the available labor supply relative to what it would otherwise have been. Not only is the law likely to reduce illegal immigration, which is estimated to be about one million persons annually, it may also reduce the 'grey legal immigration' whereby certain individuals are certified as being 'sole source' or 'one of a kind' suppliers of labor.

"Further, the law may create or contribute to an environment that discourages some legal immigration to the United States, which is also occurring at record high levels. These last two effects may be felt especially among skilled, professional, white-collar jobs, such as engineer, computer scientist, nurse, and others, which in recent years have been heavily filled by immigrants."

Alan Ewalt reflected on current immigration patterns and concluded that they are gradually restructuring the U.S. work force:

"A great number of Western Europeans who immigrated to the U.S. earlier in this century brought with them skills, craftsmanship, and a work ethic that complemented a highly industrialized society. Immigration patterns are different today. Now it flows heavily from underdeveloped areas such as Mexico, Central America, and certain Asian countries. These now generally bring a lower-level skill base, work ethic, and new cultural considerations. America's heterogenous workforce is being further segmented, creating new problems for business to integrate a multicultural workforce."

Turning to skill shortages, the panel opened a theme that kept returning throughout the day. There is great concern about a growing part of the population that is unable to work and essentially unavailable for training. Sometimes the discussion seemed to be about basic education and basic socialization; sometimes it dealt with more advanced technical skills. At times the problem was defined in terms of employer needs and the costs of finding and developing an effective workforce. At other times, it was described as "a political malignancy" growing out of weak public investment, even in the face of private affluence.

Some highly skilled professional jobs, which require years of specialized training, are going unfilled in today's economy. The panel pinpointed nursing and teaching—occupations that once were low-paid "women's work" and are in need of new entrants. Alan Ewalt said,

"The shortage is especially acute in the service industry. We find in healthcare that there are severe shortages of licensed caregivers, i.e., registered nurses, technologists, occupational therapists, and physical therapists. There is further a significant shortage of less skilled service workers, those that perform the important tasks of housekeeping, dietary, and maintenance at our facilities. Beyond this, National Medical Enterprises is experiencing a decreased applicant flow for clerical positions, and secretarial candidates with good skills are becoming more scarce.

"There is some geographical focus to this problem. Our firm is especially hard hit in New England for licensed professionals and service workers. However, the need for registered nurses, occupational and physical therapists is nationwide. Even in the areas that have suffered recessions over the last five years (i.e., Texas, Louisiana, the rust belt) the demand exceeds the supply in these categories."

Gene Remoff describes the same situation pointedly:

"Our own experience has been that certain skilled worker categories traditionally occupied by women are in short supply. Secretaries, particularly with word processing and PC skills are hard to find in major metropolitan areas. Nurses are also in short supply in almost all parts of the country. Both these occupational groups, I should note, were among the limited choices perceived to be open and available to 'young ladies' some years ago, along with teaching (teachers are also in short supply) and a few other 'acceptable' job choices.

"The number of new entrants to these occupations have not only failed to keep pace with demand, but are also influenced, of course, by local factors relating to basic education preparedness, economic growth, etc."

These comments and those of Irv Margol specifically relate to service industries and their needs for trained workers. The same statements might apply to most work, other than production and engineering, in goods-producing firms:

"One of the reasons that demand is greater than supply is that entry-level positions are becoming more and more technical—even operating a cash register seems to take special skills. This increasing technocracy is not specific to particular occupations. In my opinion, it emphasizes the need for people to have basic communication skills, awareness of technical operations, and ability to use judgment and inference.

"Within the bank, employment recruiters have difficulty filling many of the entry-level positions in banking offices and in administrative offices, chiefly in clerical and secretarial positions. Here again, the shortage of skilled labor affects our ability to fill jobs requiring basic communication, math, and other administrative functions.

"I believe the primary skills and experiential background needed to compete in the labor market today include:

- Ability to interact (communications skills, literacy);
- Technical knowledge (basic computer skills);
- Ability to make judgment calls; and
- Education (high school diploma equivalent).

"Companies will attempt to be even more competitive by becoming 'lean-and-mean.' This will probably result in decreasing or limiting the numbers and levels of middle managers. Yet communications skills will be crucial in order to act quickly; and lower-level positions will have to become more skilled to take on the responsibilities and take up the slack created by the departing middle managers."

Mitch Fromstein deals with labor supply and skill requirements in almost temporal terms. However, his framework allows for gradual adjustments to alleviate employer problems now:

"I believe the labor shortage 'configuration' is more significant than its geographic locations, as the basic causes of the shortage will eventually impact on all areas of the U.S.

"The basic causes can be categorized as follows:

- Too Few (demographic shortfall);
- Too New (technological change); and
- Too Old (disappearing skills).

"The Too Few category covers a wide spectrum of entry level positions currently unfilled. This represents the largest number of pen jobs but the lowest salary and qualification levels. Traditionally, these jobs are filled by 16 to 24 year olds with no formal training or experience. Since 1983, the size of this group, related to the population as a whole, has been reduced by 15 percent. During the same period, an estimated ten million new jobs were created, mostly entry level and low skilled. These jobs are for retail, clerical personnel, light factory workers, and general services employees. The rising and continuing demand for these workers has virtually exhausted the diminishing supply of employable people who are able and willing to accept work. It has been primarily responsible for reducing the unemployment rate to near-term record lows. This phenomenon was anticipated by demographers, economists, and planners; yet has caught major employers by surprise as it unfolds.

"The Too New category of job openings results from an acceleration in technological change. This has produced revised skill requirements accompanied by lagging training and re-training initiatives. Result: unfilled positions for office workers, computer operators, and systems operatives that require specific training regardless of past experience. The condition is exacerbated by the speed of change that often renders a set of skills obsolete even before a pool of available workers

is established. While the size of the shortfall in this category is smaller than the others, the wage levels are higher, making the positions more attractive. The shortage of new skills to meet the changes wrought by office automation will have at least a three to five year life and will persist even through an economic decline or recession.

"The Too Old category (refers to skills, not age of worker) is the smallest group of openings but the most difficult to fill. These involve mechanical skills in the industrial workplace that require a substantial training or apprentice period *and* on-the-job experience. These are the machinists, tool and die makers, and other skilled or semi-skilled factory workers whose number is being constantly reduced by retirement without a commensurate replenishing of new entrants. Many of these positions are seen to be 'dead end' in nature and old-fashioned in technology. Nevertheless, the Mid-West manufacturing belt is critically in need of these skills now. However, the shortage of traditional industrial skills should decline over the next two to three years and perhaps disappear temporarily in a downturn.

"This rather odd combination of entry level worker demand, changed skill requirements resulting from office automation, and traditional skill shortages produced by a declining industrial population has impacted broadly on the manufacturing, service, and retail industries alike. Shortages at the low end of the labor force tend to create the impression that the pool of available workers has completely evaporated. Yet we are witnessing an aggregate unemployment rate of over 5 percent. This paradox results from either a mismatch or lack of skills or geographic dislocation."

Jim Moberg agreed with this, except to point out that large companies can afford to provide technology 'catch-up' training:

"With the automation of certain jobs, employees have advanced in skills and job readiness at a rate comparable to the evolution of the technology making that automation possible. As a result, a large number of entry level positions have often been replaced by fewer positions requiring a higher level of skills. For the most part, large corporations have had the resources to train current employees for more advanced jobs. They will experience the skills rehiring/replacement efforts.

"In contrast, many small start-up companies find training programs too costly or time consuming. In rapidly changing high-technology industries, such as those found in Silicon Valley, success depends on rapid, cost-effective deployment of technology."

Before we moved on to employer responses to labor shortage, and to possible inflation pressures, the panel heard two dissenting views. Dan Mitchell disagreed with the prevailing opinion:

DANIEL J.B. MITCHELL
Director, Institute of
Industrial Relations
University of California
Los Angeles, California

"Obviously, there are spot labor shortages around. There have been New England labor shortages for the last two to three years. Nursing is another shortage area (although monopsony in the hospital industry plays a role here—as opposed to general demand for health care). But I take your question to mean: Is there a generalized labor shortage? My answer is no—not yet—but we're right on the edge.

The evidence thus far:

"The lack of a sharp upsurge in tangible wage pressures. If we were in a 1969-type situation, i.e., with unemployment at 3 to 4% after having fallen for several years, there would be notable wage acceleration. As it is, there is some acceleration, but not dramatic. So far, the pickup in wage inflation is largely a price-linked phenomenon because the Consumer Price Index has been rising a bit faster than employer costs for wages and salaries.

"Lack of a minimum wage increase. At the bottom of the wage scale, employers used to have a queue of workers waiting for minimum wage jobs, e.g., the fast food industry. But since the minimum wage has not risen since 1981, while the general level of wages has, low-wage employers who could once count on a queue are being forced to have an 'active' wage policy. Their dismay at having to behave as other employers always have, gives rise to exaggerated talk of a shortage.

"Experience in the 1960s. It is best to judge the present state of the labor market in terms of the experience of the 1960s, not the 1970s. In the seventies, there was much economic turmoil, e.g., OPEC, which made the economy much more inflation prone than now. Inflation accelerated at

a relatively high unemployment rate. The early 1960s are more like the 1980s. Both decades began with recessions. Both caused much worry about job insecurity. Both led to union wage freezes. So when did inflation begin to accelerate in the 1960s? Answer: 1964-65. What was the unemployment rate then? Answer: around 5%. Do we have a labor shortage now? Answer: Not yet, but we will if unemployment gets to around 5 percent.

"*The Conference Board's Help Wanted Index.* In absolute terms, the index is about where it was in 1979. But it has an upward trend. So vacancy *rates* are somewhat below the levels of the late 1970s."

Austin Thorne, looking down from Canada, also disagrees on the issue:

AUSTIN G. THORNE
Secretary-Treasurer
Canadian Federation of Labour
Ottawa, Ontario, Canada

"I don't think there is a current labor shortage. The nature of the job market is changing. The 1970s trend to globalization; the development of the 'hollow corporation'— the shift of production lines to lower-wage countries (the Maquiladora Industrial Zone is a close-to-home example); will continue to dampen demand for traditional male blue-collar labor in the United States.

"I think that an apparent labor shortage will not materialize because of growth in new types of jobs and growth in female participation. There will certainly be pockets of occupational shortages, particularly in the more skilled areas. This problem can always be solved with timely training. Both unions and corporations have a role to play here. However, if corporations insist on double breasting, merit shops, union busting, and look for cheap labor, rather than investing in human capital, skilled labor shortages may well get worse. Corporations cannot have it both ways.

"The shortage is being brought up as an issue mainly because employment and hiring practices are still geared to what may be called traditional labor market relationships, where employers do not fully believe in human capital, and are still treating their greatest asset—people—as if they were the corporations' worst enemy.

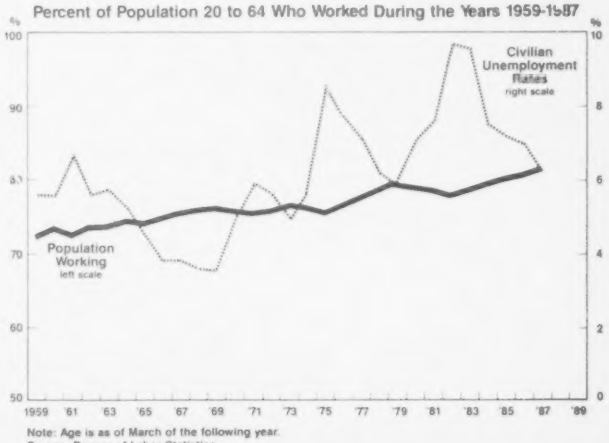
"These trends are here to stay; that is, globalization of traditional production lines, the shift of domestic labor demand from blue collar to white collar, and growing female participation. The Model T Ford production line format is no longer the mainspring of the U.S. economy. These trends are an integral part of the new age. There are new values emerging. We are in a major economic and social transition. Old assumptions no longer apply."

Finally, it may be useful to consider, at the economy-wide level, just how close U.S. emloyers have come to the "capacity level" of the population. Data are helpful here. The monthly unemployment level (the number of people looking for work during one week each month) does not give a very good "operating level" gauge for the population. Moreover, it is a single snapshot, taken out of the constantly moving employment picture.

A measure of the proportion of adults who worked during the year can indicate just how close the United States is to capacity. This measure shows a steady increase, over the past 28 years, in working adults (Chart A). The monthly unemployment rates, a dotted line on Chart A, fluctuate with business activity. But with hardly a waver, higher and higher proportions were employed, due primarily to the rising continuity of women's participation in market work.

When overall labor demand continues to expand, employers make adjustments by automating, reorganizing their businesses, training, increasing pay, and lengthening of work hours. They may try to find additional workers by locating a "niche" among the 19% of adults who

Chart A
Percent of Population 20 to 64 Who Worked During the Years 1959-1987



Note: Age is as of March of the following year.
Source: Bureau of Labor Statistics.

are not working. The composition of that group is indicated in Chart B.

Wage Inflation

There are two potential sources of wage inflation present in the economy at this point: labor shortage and rising consumer prices. Throughout the recovery years, wage costs have been increasingly moderate, especially for unionized workers. Then, in 1987 they remained stable. Now the possibility of an upturn is becoming apparent (see Chart C). The panel is predicting somewhat higher wage trends in 1989, probably in consideration of labor shortage and of consumer price increases.

At some point, the labor supply becomes so "tight" that wage inflation ensues. Employers begin to compete for workers; wage offers begin to escalate; and employee pay rates are increased also, to assure retention.

The second influence, consumer price inflation, is expected to rise to about 5% in 1989, from a current level of 4.2% (for the year ending in September 1988). Wage increases have trailed price inflation for some time, but employees may now be in a position to demand that their "real" wage be kept constant. Thus the panel's predicted wage and salary increase and CPI rise are both 5 percent.

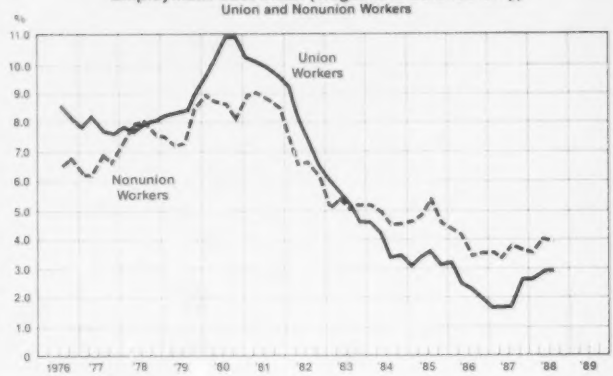
David Lewin covered the subject of wage inflation by starting out mildly:

> "At present, there is not much evidence of rapid wage/pay increases to counter labor shortages, though the most recent collective bargaining settlements and employment cost index data show modestly higher rates of increase for 1988 than for the three or so previous years (1985-87). In other words, it does not yet appear that the era of wage moderation that the United States has recently been experiencing is at an end.
>
> "However, the problem with this interpretation may lie with the evidence on which it is based. Consider first that numerous types of wage/pay payments, which have grown in popularity in recent years, are or may not be included in national earnings, wage, or pay data. These include payments under employee profit sharing plans, distributions under employee stock ownership plans, and perhaps also certain lump- sum payments.
>
> "Second, it is not at all clear that the wage/pay increases obtained by employees who change jobs and/or employers are reflected in national pay data. Because the extent of such job/employer changing is apparently on the rise and because large differentials are being paid to elicit such changes, this may be a very important omission from national pay data.
>
> "Third, owing to the pressures of competition and the real success that many employers have achieved with respect to labor cost containment,

Chart C

Employment Cost Index (Wages and Salaries Only)

Union and Nonunion Workers

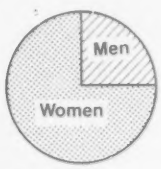


Source: Bureau of Labor Statistics.

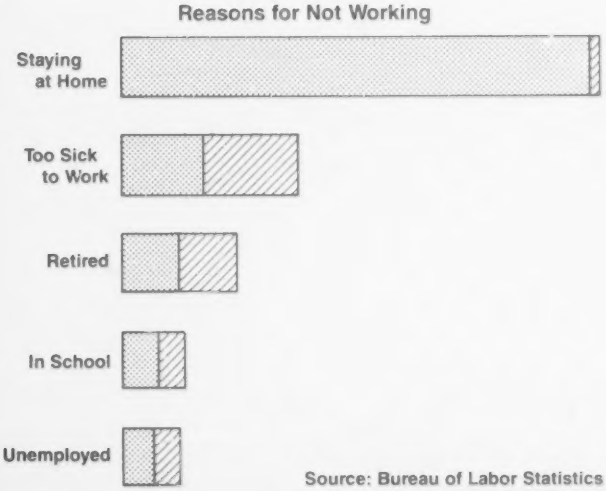
Chart B

Adults (20-65) Who Did No Work During 1987

(26.8 Million, 19% of the Population)



Reasons for Not Working



Source: Bureau of Labor Statistics

these employers are reluctant to 'reverse course.' Consequently, many of them have developed flexible work systems and/or used part-time and contract workers (contingent workers) to deal with labor shortage. Further, many of them have reduced their work load much less than they have reduced their work forces—or even not reduced their work load at all. Thus, there is good reason to believe that individual employees are now doing 'bigger' jobs and that the span of (supervisory) control has declined markedly.

"Fourth, some employers have substituted capital for labor via automation and other technological changes, or in some cases supplemented labor with capital. After all, a deepening labor shortage makes capital relatively less expensive so that employers have an incentive to 'hire' more capital relative to labor.

"Nevertheless, with the extent and types of labor shortages that loom in the near future, I expect to see more rapidly rising wage/pay rates, the pirating of employees by employers—including middle-management employees who will be in high demand by successful start-up businesses that are entering the growth stage—and, for some jobs, the development of world labor markets. This, in turn, should feature a labor market in which 'power' shifts away from employers toward employees."

Mitch Fromstein considers all the economic factors, including a change in institutional practices, and says that moderation will not be thrown aside at this late stage of recovery:

"The shortage conditions will eventually cause some degree of wage inflation and, in fact, have already done so in selected geographic areas, such as New England. General wage rates in the shortage categories, however, have not shown the 'usual' inflationary trends. The reasons for the slow increase could be many. General costs of living have risen very marginally, reducing the potential employee pressures for higher wages. Most companies have striven to keep their workforce costs under control and, therefore, have resisted wage inflation as a short-term solution to filling open positions.

"Simply offering more money does not necessarily solve the problem in many of the shortage categories. In the new skills areas, for example, operators of newly introduced hardware or software are not available at any price since they do not exist. Perhaps there is an underlying caution that inhibits most employers from an unhampered workforce build-up. Perhaps 1980 is still fresh in many business psyches or the threat of foreign competition acts as a barrier to the build-up of fixed costs. Perhaps the contingent workforce acts as a buffer to increasing core workforce shortages."

Austin Thorne agreed with one of those points:

"The low-wage countries and the U.S. merchandise trade deficit are keeping pressures on wage inflation."

Jim Moberg is not expecting wage inflation on a general scale:

"At the very top levels of management, finance, and science there will be some inflation. However, there will also be strong competition among potential candidates for these gold-collar slots. Would be executives are being very careful in their section of life experiences to ensure that they can pack in the educational and work backgrounds that will justify the competitive salaries.

"At the middle and lower levels, wage inflation seems unlikely. The memory of layoffs due to recessions, industry shifts, and downsizing are still very much in people's minds. Employees expect a great deal from their jobs, but money is not the only priority. Employees now evaluate the value of their jobs in terms of total compensation, adaptability to life style, and opportunity costs."

Gene Remoff considers the wage pressure intense at the low end of the scale. Most of the panel agreed with this point.

"Certainly, among employers who have (or see) no alternatives if they wish to continue operating, wage inflation becomes the answer. But because passing along wage increases in higher prices is more difficult than ever before, many employers are trying to 'hang tough.' This is particularly true of those goods-producing firms that face direct competition from off-shore, and services firms that have to concern themselves with substitutes for their services or the threat of customers choosing to live without their offering.

"Similarly, I've noticed employers talking tough (privately) about not letting a minimum wage increase trigger a ripple or compression effect upward to succeeding higher levels in their workforces.

"Nevertheless, wages in many regions at the low end of the job market are moving up rapidly. Rates have climbed very quickly where all the employer has to offer is a job, not a career and where the labor force is absolutely essential (such as in retailing and services). Here also when the employee doesn't identify the workplace as a home, he or she is easily recruited to work next door for another 20 cents an hour.

"Alternatives are clearly being sought. These include use of contingent workforces that do not upset the firm's internal wage structure. Also special one-time incentives such as hiring bonuses and employee referral bonuses are being employed, and new workers anxious to join the workforce at lower prices are being recruited, trained, and accommodated, where necessary, with changes in job task design."

Alan Ewalt agreed:

"Wage inflation is taking its toll in certain market segments. There is upward movement to attract and retain, yielding more compression."

Within banking, Irv Margol sees similar effects. However, he returns us to the shortage discussion by mentioning the unskilled population again.

"Though 'stealing workers' exists, it is not prevalent throughout all functions within the banking industry. Within the merchant bank, it is more widely practiced but not at a pace that would cause wage inflation over a long term.

"At the executive levels in the bank, stealing workers has only been significant with the last few years. Headhunters support wage inflation by placing good candidates in high-paying senior or technical-level jobs.

"It is oftentimes difficult to fill secretarial and clerical positions in downtown areas, such as Los Angeles, due to less-than-attractive commuting situations and the high costs of parking, food, and dress. Thus, 'stealing' efficient secretaries occurs not only between companies but also within companies.

"At this point in time, I believe that wage inflation is primarily the result of the imbalance between the growing unskilled population and the limited-skilled labor force. Before the current labor shortage, employers were able to recruit people at lower wages. Now, with the tight labor market plus the rally to increase the minimum wage, employers are having to increase salary minimums at all levels, including entry level positions."

Dan Mitchell—who has just said that the low rate of wage increase is evidence that there is no generalized labor shortage—says employers resist raising pay:

"They make do and try to recruit with every tactic short of wage raising. Employers regard wage raising as a last resort. Why is this? If I knew, I would have the Nobel prize in economics sewed up. But the descriptive story is very old.

"I am not saying that some wage raising is not going on. The Employment Cost Index shows faster rates of wage increase in the Northeast than elsewhere over the 12 months ending June 1988. But it's not enough of an increase to clear the labor market, choke off excess demand, and equalize Northeast unemployment rates with those elsewhere. The *usual* result is not wage inflation at first. The usual response is everything else first, wage inflation after."

As a result of this discussion, the panel was very close to unanimous on wage and salary increases in 1989. The full range of their prediction (Table 1) was narrow: 4.2 to 5.4 percent. This corresponds to the projections obtained by The Conference Board's compilation of compensation surveys (see box), but the panel's figures are a bit lower.

What are Employers Doing to Overcome Labor Shortage?

This discussion revolved around training and qualifications. A major point, raised by all participants, is that there are dramatic problems among inner city youth that employers cannot solve by training. This permanently excludes some people from the potential labor supply, and makes it unlikely that they will ever be self sufficient. Even the illiterate, with social and interactive skills, would be able to fill some service jobs. However, their lack of self-esteem is a barrier to the social communication necessary for entry level work. Mitch Fromstein described the joy of adults who discover, through a Manpower testing program, that there is one thing that they can do successfully. But unqualified, socially isolated minority youth seems to be unreachable by employers, even when they are concerned about the economic and social pathology of this "underclass."

Gene Remoff:

"This is a real (as opposed to imagined) problem in the inner cities. I see it in my own neighborhood in Philadelphia which, as it goes through the process of gentrification, contains a wide range of socioeconomic and cultural conditions from welfare-dominated, drug-infested public housing projects to affluent town-houses with prep-school children ushered off to exclusive private institutions each school day.

"There is a growing underclass, and it will be a plague to those in it and those who eventually must depend on it if not addressed. The children of such conditions are insufficiently educated to meet the basic skill requirements of most entry level jobs. By the time they are teenagers, many have substance abuse problems. A portion of those who

A SURVEY OF SURVEYS: SALARY PLANS

Organization	Level of Employee	1988 Salary Increase	1989 Planned Salary Increase
		%	%
American Compensation Association	Executive	5.6	5.5
	Exempt Salaried	5.2	5.3
	Nonexempt Salaried	5.1	5.1
The Conference Board	Executive	5.4	5.3
	Exempt Salaried	5.0	5.0
	Nonexempt Salaried	4.8	4.8
ECS, A Wyatt Data Services Company	Executive	5.4	5.4
	Exempt Salaried	5.1	5.1
	Nonexempt Salaried	4.9	4.9
Handy Associates	Exempt Salaried	5.1	5.1
Hay Management Consultants	Executive	5.7	5.2
	Exempt Salaried	5.3	4.9
	Nonexempt Salaried	4.5	4.5
Hewitt Associates	Executive	5.6	5.6
	Exempt Salaried	5.0	5.1
	Nonexempt Salaried	4.8	4.9
William M. Mercer Meidinger Hansen, Inc.	Executive	5.7	5.6
	Exempt Salaried	5.3	5.3
	Nonexempt Salaried	5.1	5.1
Sibson & Company, Inc.	Executive	5.8	5.5
	Exempt Salaried	5.2	5.2
	Nonexempt Salaried	5.0	5.0
TPF&C, a Towers Perrin Company	Executive	5.2	5.3
	Exempt Salaried	4.9	5.1
	Nonexempt Salaried	4.8	4.7

In the majority of cases, the 1989 planned increases are the same as the 1988 increases. This is the same pattern as last year. These constant rates of increase contrast with the generally downward trend reported in the prior four years. The question for 1989 is the rate of inflation. If inflation lags behind salary increases, as has been the case for the last several years, there will be a real earnings gain for employees. Also contributing to employee earnings, but not reflected in the data above, is the increasing use of variable pay programs.

Charles A. Peck
Senior Research Associate

Data compiled by:
Elizabeth R. Arreglado
Research Analyst

are able to qualify for the demands of jobs requiring little or no education, balk at the low pay or, if single with child, the real cost of going-off welfare. The role models that might encourage, coach, and facilitate their entrance into the world of commerce and industry have justifiably escaped nasty ghetto living conditions and moved away to now—accessible better housing and better schools.

"Too many of these inner-city young people who could otherwise be members of the workforce, are without socially acceptable kinds of aspirations to get ahead and with little hope of building self-esteem except in criminally related activities. The lack of such reasonable aspirations and hope is frightening. We've seen it breed frustration and violence in the past.

"Many employers, particularly small independent proprietorships and managers of retail and service establishments have historically concerned themselves only with the task of *selection* in staffing their operations. Now faced with tight labor markets, many must direct considerable effort and skill to generating applicant traffic from which to make their selections, moving quickly on early qualified candidates, modifying job requirements to accomodate available skills in the labor market and then orienting, supporting, and otherwise encouraging those persons they hire to stay with them. Many employers are missing either (or both) the skill or the desire to deal with such recruitment and retention issues. When they don't do well in these areas, what might otherwise be a time-diverting task to be managed like all other tasks, becomes a crisis and a shortage."

Mitch Fromstein suggested that employers are the best agents of social change, because there is an employability focus to their efforts.

"Training, in our society, has been severely short-changed at the worker level. We have invested in management training but have left training of the foot soldiers of the labor force to the public school system. We must now confront the issue of creating and building the skills that are short, using techniques that avoid the traditional pitfalls of our educational system.

"Business firms must commit resources to training; management must drive the process. The focus must be on incremental task training. The one-person/one-task concept is now obsolete. Instead, we need the ability within each company to enhance, modify, or replace human skills with speed, efficiency, and at a reasonable cost.

"Government programs are costly and cumbersome; school programs are too slow; and joint partnerships are ineffective on a large scale. The job must be done by companies themselves and tailored to specific and ever-changing needs. Proof that it can be done lies in Manpower Incorporated's initiative, which has successfully (and economically) produced exactly the skills required to fill client company orders for people on a short time scale—and in large numbers."

Irv Margol agreed:

"Employment of a less-skilled work force, because of the declining quality of education, will force employers to redefine levels of job competency. With the lack of a technically adept work force, businesses will be required to evaluate basic skill levels, using, e.g., aptitude testing. As a result, I believe the re-education of our work force may have to be initiated by private enterprise if we are to adjust to increased technological demands. For example, corporations may find it beneficial to create 'partnerships' with formal education and/or advocate groups (e.g., the Urban League)."

David Lewin expects the maturing U.S. labor force to be of higher quality in coming years, yet,

"There will still exist a low quality component of the workforce. Rather than simply reaching down to hire such workers, however, employers will have an incentive to train them in order to raise their skill levels. Put differently, employers will be able to 'buy' certain low quality labor and then 'make' it into higher quality labor. There will be an incentive to do so in that labor markets will be tight. However, the costs of such training must be weighed against the costs of capital, technological change generally, and automation in particular when making such decisions. Note further that this type of expenditure is likely to be more effective in raising the productivity of low-skill or unskilled workers than efforts by businesses to improve the public schools—that is, to improve general education. The tricky part of this is that employers who provide training, including on-the-job training, will have to figure out ways to keep the newly trained employees long enough to reap the benefits—the higher marginal output—that flow from such employees. Short-term employment contracts may be one useful mechanism in this respect."

Jim Moberg summed up the feeling of the entire panel when he said:

"Responsible leaders must take a look at the broader picture. If our national skill level is deteriorating, as the current and projected demographics suggest, everyone will be at risk. We cannot afford to accept the rift between the employable

and the unemployable. We will have to draw from the available population, adjusting the new training needs of the employee. Obviously the cost will be high, driving corporations to use whatever influence they can to mitigate the problem in cooperation with the education systems."

The panel was unanimous in suggesting that *retention* of employees has a high priority at present. The costs of retraining are lower than costs of recruiting and training new workers in today's environment. (For the first time in years, there was no discussion of downsizing and layoffs.) The conversation moved in this fashion: "Employers are more interested in retention because they must be." "People that we have trained are loyal and stay with the company." "Older women are basically literate and show commitment." "We are having no trouble retraining. Our people now expect three major job changes over a lifetime, on average." "We no longer offer security; we do offer an opportunity to learn, to develop, to acquire (at the company's expense) skills that are marketable." Mitch Fromstein responded to the last speaker, "You are in the temporary help industry. You just don't know it."

A discussion of retraining and retention should include middle managers, according to Irv Margol:

> "Due to the occurance of downsizing within Corporate America, we are seeing unemployment rising in the middle-management and white-collar ranks with increasing predominance. We are also witnessing an acceleration of technology within the work place. The combination of these two phenomena—downsizing and technology—will force the initiation of retraining Corporate America to become a major policy issue.
>
> "Management will have to take an intelligent approach in developing retraining programs. The focus and scope of many of these programs may have to be targeted toward middle and senior levels of management. We cannot utilize the small training programs, as we have in the past. As well, human resource managers will have to assume a more proactive role in the training and development of middle management."

Gene Remoff offered a comprehensive statement about employer response to labor shortages, particularly applicable to service firms:

> "Many employers will need to become more skilled and dedicated to the recruitment and retention dimensions of staffing. Those of us who are major employers in services businesses that are geographically dispersed in small units (with no on-site personnel professional) are investing in the training and education of our local managers regarding this issue. We are also seeking ways to generate candidate traffic for these locations using appropriate regional recruiting staffs. I would suggest that firms who find recruiting a new experience consider tapping into the skills of engineering recruiters who have, over the years, developed not only the personal and organizational temperament for recruiting a scarce human resource, but also some of the techniques and disciplines that are involved.
>
> "Certainly, employers are also revisiting their stated qualification requirements, some of which in the harsh light of labor scarcity do not seem as relevant as they once did (i.e., a high school diploma, a college degree) to performance in the immediate job opening.
>
> "I doubt that any employer admits to lowering employment qualifications to the 'if you see lightening, hear thunder you're in' level, but certainly in some firms marginal and previously unacceptable applicants are being employed and given previously unoffered company training to bring their capabilities into the acceptable range.
>
> "We're also seeing job redesign attempted with more frequency. The objective here is either to accommodate the job tasks to available skills (a return to job simplification) or to remove undesirable duties and conditions so as to facilitate recruitment.
>
> "This labor shortage is also a wonderful opportunity for persons in unreasonably stigmatized circumstances to now show what they can do in the work place. And what they can do is often prodigious. Persons with certain physical and mental disabilities are now enlarging their records of dedication and productivity, as are the elderly. Also, occupations previously kept hidden from minority and female candidates must be opening up to them.
>
> "There are other competitive edges that when examined on a cost-benefit basis may make sense to a firm with a tightened labor market. To some extent, particularly where the shortages have been pronounced, urgent, and sustained (such as the need for nurses) these practices are already in evidence. They include offering flexible, part-time and work-sharing schedules, on-site child care, elder care assistance, hiring bonuses, employee referral bonuses, and a variety of other benefits targeted to the particular labor market population.
>
> "While employers have been increasing their use of what you have tagged 'contingent work forces' for a number of other reasons, the use of subcontractor service management firms dedicated to a particular set of job tasks and functions has a particular appeal in tight markets. An organization

whose basic reason or mission for existing is built around a particular primary work force is not typically seen as a good career employer by a much needed manager or set of specialists in a support discipline. However, these individuals are attracted to employers whose main purpose is to provide (and reward) their kinds of personal disciplines and skills.

"A good example is the comparative attraction of a position to a food service manager or chef who would be employed directly by a hard-goods manufacturer, or, alternatively by a service management firm that provides food services operations to many organizations. Career opportunities, training, recognition, and professional standing are much more substantial with the latter employer. Similarly, a medical director-physician employed directly by a warden to staff and operate a prison medical center is going to find employment with a specialized national provider of such services to prisons more compatible and attractive."

One of the potential sources of additional workers is the ranks of the "early-retired." About one eighth of the non-workers shown on Chart B are retirees younger than 65. Panel members considered an employer strategy of finding and employing older workers. David Lewin said:

"The problem with this policy option is that U.S. workers have shown a productivity for retiring early. To be specific, the average age of retirement in the United States dropped from 63 years of age in the 1960s, 1970s, and early 1980s to 62 years of age in 1986, according to Social Security Administration data. Moreover, continued reductions in force being carried out by some U.S. companies provide certain incentives for early retirement rather than for extended work life. However, it is also true that many 'RIF-ed' employees seek and find work elsewhere, some start their own businesses, and some are rehired by their original employers as consultants or part-time employees. These arrangements suggest that it may be possible to extend the work life of a portion of the work force. Nevertheless, the labor force participation rate of the male 55-year-old-and-over cohort continues to decline so that, on balance, the concept of extending employees' work life may have limited practical application."

Gene Remoff agreed with Lewin, but suggested more flexible working arrangements as an enticement:

"People seem to want to retire earlier in life rather than later, despite a ban on compulsory retirement age. They do have an interest in part-time employment, however, since they are often vigorous, still interested in what happens in their area of expertise and have a desire to supplement their income. We will see more scaling down of hours and less abrupt retirements, particularly as we become more comfortable with flexible work schedules, job sharing and individual contract labor (which can include ex-employees). This is already happening in management ranks as a way of reducing overhead staffs through attrition while maintaining access to the kernel of expertise that such a heavily experienced staff person can continue to contribute as a part timer."

Alan Ewalt observed that economic necessity will retain many older workers, even without special employer inducements:

"Extended work life beyond the age of 65 is an alternative that seems to be compatible with both the demands of business and the economic demands on our aging population. Social security does not match up with the cost of living and lifestyle expectations of seniors. There is also increasing realization that retirement is not the ultimate. Today's seniors are healthier than ever with the prospect of living well into their eighties. Twenty years ago retirement was viewed as likely to be of a much shorter duration. Many seniors want to continue to be productive in their 'golden years.' They can only fish so much. Our firm has a sizable work group over age 65."

Irv Margol suggested several ways that companies can stop the early retirement trend:

"Bonuses can be offered to employees as an incentive to delay retirement. Other incentives may be provided to retain workers through the improvement in the quality of their work life. Job fit, diversity, and re-education are examples of incentives that may capture the employee's interest to remain on the job for an extended period—in their present position or in a newly learned position. As well, employers may look to more varied ways of retaining workers by providing job flexibility in forms to include: job rotation, working-at-home, flextime, job-sharing, and part-time options.

"In addition to providing incentives to extend work life, raising the retirement age and/or increasing the 'points' to reach retirement age may discourage early retirement. Changing retirement policies could be employed by a two-tier system to determine retirement age. This would include one set of requirements for current employees and another set for new employees as of a specific start

date (with an adjusted retirement age and point system)."

One of the possible respones to a shortage of workers is to conserve labor—that is, manage to get more output from each employee. Productivity gains, then, are a beneficial result of labor scarcity. Raising labor productivity is the basic management "art." It may involve reorganizing business structure and reducing layers of hierarchy or bureaucracy. It often includes use of more advanced capital equipment. Training and development of human resources are also contributors to raising output per employee. Productivity solutions to labor shortage tend to penetrate to the heart of the business more thoroughly than human resource strategies alone. Interestingly enough, management moves toward higher labor productivity are not always consciously controlled by a felt labor shortage. It is there, nonetheless. Under conditions of labor oversupply, such as the United States experienced during the 1970s, labor productivity tends to lag. Who needs to obtain higher output per worker, when workers are plentiful?

Alan Ewalt discussed this kind of productivity attention in his industry.

> "Work design in the service sector is becoming a more critical consideration as companies try to minimize demand for scarce talent by increasing productivity. Our own organization has developed a program of team healthcare called Care Giver, where we utilize the registered nurse to do the most skill intensive work while other competent but lesser skilled employees do the less demanding tasks.
>
> "We are redefining jobs to the extent possible within the scope of licensing requirements. Task forces are further evaluating new licensed positions with different job makeup and capabilities. The American Medical Association has proposed a new caregiver specialist who would report directly to the physician as another response to the nursing shortage. Although the AMA proposal has met stubborn resistance with nurses, it is a clear signal of physician frustration with the nurse shortage.
>
> "In an economy that is more and more service oriented, the challenges of raising productivity are particularly difficult. The addition of capital does not do much for the transportation industry, the health care industry or the hospitality industry. Health care in particular has the dilemma of the addition of technology decreasing productivity. More sophisticated equipment to do specialized procedures generally means more technicians and more maintenance support. There are some productivity advances. Automated laboratory equipment has been helpful. Arthroscopic surgery is faster. Noninvasive cardiac procedures use much less labor than previous methods. These improvements also stimulate demand which offset the net

Jim Moberg sees productivity gains in delayering:

> "Another area where we have seen many positive effects is in the restructuring of organization to streamline the decision making process, eliminate duplication, and achieve more efficiency in work groups. However, one still sees many situations where routine tasks are performed frequently and repeatedly. There is plenty of room to improve in the area of making better use of an employee's time through organizational change and automation."

Two of the panel members are in firms that offer subcontracting services to other businesses. This allows some productivity gains by focusing labor hours when they are most needed and most appropriate. Gene Remoff said:

> "ARA Services, Inc.'s experience is that the expert subcontractors in the contingent group are typically more productive at what they do than the self-operator with a different primary business to run, who becomes their client."

Mitch Fromstein added:

> "As the supply of labor diminishes, companies will access outside support organizations to provide scarce skills on a timely basis. This capability will become steadily more attractive because it combines flexibility in labor costs with availability of scarce skills. The temporary help industry has perfected the use of good screening and selection techniques, effective task training, and the use of women, retirees, and students to provide a peripheral source of supply to the labor market. I would expect this role to continue and expand in the tight labor market of the 1990s."

New Federal Government Initiatives

Nearly all discussion of this subject was concerned with healthcare. Having an increasingly mobile work force, alongside a fixed employer-based benefit system, is counterproductive. If employers want to improve the flexibility and mobility of workers, for maximum efficiency, then they should devise some portability for benefits. There was a consensus that some form of employer-mandated health benefits would be passed in Congress within two years, though the package configuration is not yet clear. One objective of all recent benefits

regulation is to produce equal treatment among employees and their dependents. At least one panel member feels that a mandatory comprehensive package is a first step toward nationalized healthcare; but three others objected that the approach will continue to be piecemeal.

Unfunded retiree health plans were described as more of a threat to larger, older companies than the current rate of benefit inflation. Reverting to the national health theme, one panel member asked: "Do you want unfunded liability to be on corporate books, or on national accounts?"

The Eldercare issue will build slowly over several years, according to Irv Margol:

> "Congress will continue to address the area of long-term health care, more specifically, the catastrophic care provision associated with the recent Medicare bill. There appears to be several limitations to this present bill, as it does not address the need to provide maintenance coverage for a growing aging workforce. As the baby-boom generation ages, medical coverage for an aging population will be at the forefront.
>
> "At present, there are no corporate tax deductions available to support maintenance programs that provide coverage to the retirees and elderly. These are not considered 'benefit' programs, per se. Congress will need to feel increasing pressure to deal with long-term care issues whether they are implemented by mandating federal programs or by assisting corporate incentive programs."

Gene Remoff described the implications of all this for cash and non-cash compensation:

> "Traditionally, human resources practitioners have avoided trading off one element of compensation designed to meet a certain need or demand, with another element aimed at some different target. The 'rule' was that cash and non-cash (benefits) compensation were to be kept separate.
>
> The lines have blurred and are becoming all but non-existent. Benefits cost big dollars. Healthcare costs to employers are still out of control (once you've introduced all the available cost-containment techniques).
>
> "Furthermore, the benefits being sought and offered today are recognized by present and potential employees as compelling items that would otherwise require them to lay out cash now. The *cost* of the total compensation package is now well recognized by employees as well as management, because benefits increasingly require employee cost-sharing (co-pay of healthcare insurance, defined contribution retirement plans, etc.). Also, relative values are made visible in cafeterial plans. Discrimination testing and its implications under the 1986 Tax Reform will add further emphasis for those in the 'hi-paid' group.
>
> "These increasingly sophisticated recipients of compensation are at the same time learning that their compensation package is finite and cannot be passed on by their employer (in price) in an increasingly competitive global marketplace.
>
> "My point is that employees will learn from their employers that they themselves will pay the price when benefits are mandated because the cost will come out of some other piece of their compensation pie. How well and how quickly this will be understood, I'm not sure."

The panel expects some changes in Social Security. Several members think that the provision limiting earnings of Social Security recipients will be removed, or the limits will be raised substantially. This would encourage retirees to re-enter the workforce. On the other hand, one panel member believes that the wealthy retired may be removed from benefit rolls. And two observers expect some further increase in the maximum income subject to Social Security tax (above its 1989 level of $48,000), in order to produce new revenue.

David Lewin, in one of two proposals for major changes, suggests:

> ". . .more individual freedom and decision-making. I expect to see a groundswell of support for letting individuals decide if they want to contribute to Social Security for only part, not all, of their work life; for letting individuals make investment decisions for at least a portion of their Social Security contributions; for letting workers covered by private pensions, especially those with vested pensions, opt out of Social Security in part or in whole; and for letting certain groups of employees contribute more *or* less to Social Security than is allowed under present standards. All of this is consistent with a more highly educated work force that is more cognizant of financial and investment matters than prior generations.
>
> "As to the earnings limitations for recipients of Social Security payments, this is a regressive 'tax' which is counterproductive, inequitable, and at odds with the principle that underlies virtually all other public and private pension/retirement plans. Indeed, the fact of early retirement 'sweeteners' provided by many employers in recent years to reduce their work forces has resulted in some individuals receiving a full pension from their previous employer and a full wage or salary from a new employer. These individuals are not penalized by their first employers in terms of having their pension benefits reduced just because they have taken

new jobs or returned to the work force on a part or full-time basis. The same principle should be applied to Social Security, and I believe that the Congress and the next administration will be pressured to make this change in the law."

There was no consensus on congressional day care initiatives, partly because the panel sees no public consensus on the issues or strategies involved. Some felt that a parental or family leave bill might pass; some expect a tax credit or other incentive to provide for day care costs. The panel was in agreement on one aspect of the day care subject: Employers who need women workers will increasingly offer some assistance in day care, to attract this niche supply of workers (see Chart B).

A federal minimum wage increase is expected by all, possibly with a subminimum to overcome employer preferences for workers beyond the teenage years. In this context, David Lewin produced a "radical" proposal:

> "I believe that during the next administration there will occur a reexamination of labor market and human resource regulation, especially such older regulations as Social Security and the Fair Labor Standards Act (FLSA). For example, the overtime provision of FLSA makes less and less sense in a highly competitive economy and in tight labor markets. Requiring pay premiums with the intent of encouraging job creation and/or work-sharing is, if not an outdated concept, certainly one that needs re-examination—and I think such a re-examination may well take place in the 1988-1992 period. Should this occur, however, it will very likely be in the context of a wholesale re-examination of FLSA, including the child work restrictions, female work limitations, and minimum wage provisions of the law. I expect the first two of these to be loosened and the last to result in a 'new worker' minimum wage that is, in effect, a subminimum wage. It is further possible, given recent changes in the U.S. tax law, that the dividing line of 20 hours per week between full and part-time work will be reduced to 17½ hours."

Drug Testing

Panel members stepped gingerly around this subject, noting the legal and privacy issues and the fact that testing is burdensome and expensive. Gene Remoff:

> "The use of applicant drug-testing is on the increase due to:
>
> 1) The proven reliability and validity of double-screen testing when done by confirmed, reliable testing houses.
> 2) A felt need to defensively test, to avoid being identified in one's community as part of a developing minority of employers to which drug users can gravitate for employment.
> 3) Testimonials by employers as to their believed or demonstrated reductions in accidents and increases in productivity after instituting drug testing. Concurrently, we have seen and will continue to see a growth in the use of Employee Assistance Programs as employers seek to:
>
> a) Help employees deal with substance abuse problems.
> b) Provide supervisor referrals (versus self-referrals) of employees to the EAP for exploration of suspected substance abuse and potential treatment.
>
> "Drug-testing of present employees, random or otherwise, is a subject being addressed in the courts. It is also a practice that, given its intrusive nature, does not have great support among human resources practitioners, except for certain potentially life-threatening occupations where substance abuse is a threat to other employees, customers, and the public at large.

Dan Mitchell expects the subject to fade into obscurity:

> "Drug testing will be done by some employers for new hires and risky jobs. There will be more litigation alleging improper testing, faulty tests, and smeared reputations. Horror stories will continue about someone who eats a poppy seed bagel and tests positively for cocaine. States will begin to pass laws (as with lie detectors) that provide employee protections against false test results. Employers who do extensive testing will begin to notice the costs and wonder why they are doing it. The issue will begin to recede from the national media; it will become a minor technical matter in personnel administration, almost as exciting as payroll accounting procedures."

If I were President...

Panel members did some careful thinking about what human resource policy initiatives they would pursue, if they had been elected president. Some of their responses follow:

Moberg:

> "Probably no issue is more important in the area of human resources than the affordability of healthcare in America. The rise in health care costs is a concern to all of us.

"Medical cost increases defy the rules of economics: Despite more physicians, more hospitals, more choices in medical procedures, competition has not driven down the cost of healthcare. Medically related services and products represent 11.2% of our 1987 Gross National Product (GNP)—more than double the proportion found twenty-five years ago. Medical inflation consistently exceeds that of all other categories.

"The president should develop a national healthcare policy, because this problem cannot be effectively addressed by the government or the private sector alone. Simply deciding who will pay is not the problem; the problem is that health care itself is just too expensive, and we must lower costs. One approach is through a well-coordinated national healthcare comprehensive coverage from pre-natal through eldercare. We need to address questions of healthcare education, standards, and accessibility.

"Many life-threatening illnesses are linked to lifestyle. Stress, and behaviors such as smoking, eating too much, too little, or the wrong foods, lack of exercise, and alcohol and drug abuse lead to more serious ailments.

"Wellness programs must replace illness programs. Employers and medical insurance carriers can do much to encourage this change by reimbursing programs that address the underlying causes of serious illnesses and not just their symptoms.

"Along with being better educated on the nature of illnesses, consumers also need to be better educated on the nature of medical care and the choices available in the selection of treatment. The consumer needs to know what the alternatives, as well as the potential outcomes, are for medical treatment. The mystique of medical care needs to be removed so that the consumer can make cost-effective choices.

"Because there are no universally accepted standards within the medical profession itself as to what constitutes appropriate care, it is difficult to establish boundaries between socially acceptable care and the theoretical limit of available care. But the cost factor forces us to ask whether it is more ethical to offer at least good care to all, or only the best care to a few.

"The public should be protected from negligent or substandard care. But the cost of current malpractice insurance drives up the cost of medical care. In some high-risk specialties such as emergency room care and obstetrics, malpractice insurance costs have driven physicians out of the field, thus reducing the accessibility of care."

Austin Thorne:

"If I were elected president, I would be obliged to recognize that the multinational search for a better bottom line in low-wage countries is creating major social costs at home; directly in some three million lost jobs, and indirectly, as non-multinationals have to pressure U.S. workers to accept lower wages in order to compete. The U.S. is allowing their own 'gods' to undermine the basic prosperity and standards of living of all Americans. If you think about it, you have to recognize its absurdity. It is a guaranteed formula for economic and social decline.

"The administration is going to have to address both international economic performance (protectionism is not the answer), and start a new humanizing trend for the work place and community. Larger corporations will squawk and resist. But I think if they do not adapt, they will go the way of the dinosaurs.

"The next administration will have to come to grips with the major social issues. U.S. corporations have to develop a new social ethic and a new code of conduct. Pressures for a clean environment, occupational safety and health, adequate medical insurance coverage for workers and communities affected by hazardous substances, and humanitarian treatment of workers on layoff and closures will grow.

"For example, I think corporations have to look seriously into whether it will be cheaper to clean up their act or face exposure to increasing liability lawsuits. The Johns Manville and Bhopal cases should be a salutary warning in one area. Corporations must recognize that 'clean doorsteps' are important, particularly at home, and for different reasons, if the U.S. is to show world leadership abroad."

Dan Mitchell:

"In 1945, as labor-management frictions (which had been suppressed during World War II) began to explode, the president called a conference of union and management leaders. They could not agree on anything much except that rights arbitration was a good thing. However, the main issues of the period, mainly management vs. union rights, at least came to the surface. Within a few years, the outline for union-management relations for the next couple of decades became clear. By 1955, everyone knew how the game was to be played.

"We need a new conference. This time it should be focused on the employer-employee relationship (rather than the union-management relationship, since the vast majority of employees are nonunion). Specifically, we need to define just what the employment contract does—and does not — contain.

"Let's look at all the issues: terminations, layoffs, use of pension plan funds for funny purposes, continuation of benefits, etc. Let's come to some agreement about who owes what to whom, with appropriate distinctions between 'regular' workers, contingent workers, etc. Let's stop using EEO, workers compensation, and other programs, as a *de facto* national grievance procedure. Let's have *written* individual contracts defining rights and obligations on both sides, so that everyone knows what is expected. (Implicit contracts are worth the paper they aren't written on!)"

David Lewin proposes a similar initiative, along with two others:

"I would submit to the Congress a National Employee Rights Law (NERL) that would define and standardize the basic rights of employees and employers in the employment relationship. Such legislation would seek to overcome the patchwork quilt of state and local laws and court decisions pertaining to unjust discharge situations. The law would first and foremost preserve the employer's right to hire and fire 'at will' and the employee's right to seek employment and quit a job 'at will.' That is, the law would restate and codify the notion of a free labor market. Beyond this, however, it would set forth basic minimum rights and obligations of both parties to an employment relationship, support but not require explicit employment contracts (but, where they exist, support the enforcement of such contracts), and support but not require internal procedures and systems to resolve disputes arising out of individual employment relationships. The law would also be intended to reduce the currently voluminous litigation over employment-at-will/unjust discharge. Further, it would declare it illegal to employ a person 'off the books' and/or to avoid payments to and deductions for unemployment insurance, workers' compensation, Social Security, etc.

"My first initiative, however, would be to place all federal expenditures for public education, as well as the administrative apparatus for those expenditures, in the *defense budget*. We tend to think of defense expenditures as those devoted to hardware or capital—weapons systems, military bases, computers, nuclear arms, etc. Yet a very strong case can be made for the inclusion of expenditures for human capital in the defense budget, that is, thinking of education and training as a 'weapon.' I believe that this would also help to address and bring about progress on such matters as lengthening the school year, supplementing state and local expenditures for teacher salaries in order to attract high(er) quality teachers to public (and private) education, and providing national minimum competency standards in mathematics, science, computing, literature, history, and the humanities—especially for high school graduates.

"Next, I would propose to the Congress certain changes in the federal tax code that would authorize deductions or tax credits for individuals when they search for new jobs and when they relocate to take new jobs. These measures would be aimed at enhancing labor market mobility. There would be certain earnings and expenditure limitations on these deductions; and search/relocation expenses reimbursed by employees would, of course, be excluded from coverage of the law. I would also instruct the secretary of labor to publish monthly disaggregated unemployment rates, such as, for example, U_1 = unemployment among 25 to 54 year old heads of households, U_2 = unemployment among all heads of households, U_7 = 'regular' unemployment plus the 'unemployment' of involuntary part-time workers, plus a portion of underemployment, etc. This would follow the concept currently used in producing data on the money supply, and would help the country to avoid the fallacy of relying on an average unemployment rate that masks more than it reveals."

Mitch Fromstein took a businesslike approach and called for a process to identify and test program innovations; another process to yield better job information and higher labor market efficiency; and a system for developing job-specific training:

"If I were president I would assemble a Brain Trust group of six or seven people who represent the brightest thinking on work force issues and send them off for several weeks to debate and brainstorm short-term approaches to the problems. I would give them your list of questions as a start and ask for 20 or 30 one-page abstracts. I would select people from business, media, publishing, and academia, and demand a non-political approach with a high degree of creativity. I would then take the ten best ideas and ask the ten largest U.S. corporations to 'adopt' them with top management support and return in six months with results of experimental program and recommendation for expansions.

"I would establish a new division in the Department of Labor to be responsible for accumulating current data on job openings and for creating short-term programs to find applicants for those jobs.

"I would establish Industry Training Councils a la FDRs (unconstitutional) NRA groups and charge them with the development of industry-

specific training programs from which they would draw job applicants as the labor supply shrinks. I would appoint a human resources development czar to oversee the operations of the councils and grant them immunity from anti trust actions on a short-term basis.

Alan Ewalt:

"The nation has more millionaires than at any time in its history. It also has more people living at the poverty level and who are illiterate than at any time in its history.

"If I were president I would be issues oriented, dealing with the nation's labor shortage and toward getting blacks and minorities back to work. I would be concerned with the inner city and oriented toward amelioration of the development of a two class society, the haves and the have-nots.

"Jobs are not the only answer. A robust economy in the 1980s has still left a significant portion of our population behind. We need a policy aimed at productivity, responsibility and growth for the individual. As we strengthen the disadvantaged level of society, we strengthen all of our society."

Gene Remoff:

"I have two initiatives to offer.

Education. The development of our nation's human resources through education and training has to be the matter of primary, critical concern.

"Our failures in educating the young people of our inner cities are having a disastrous effect on their lives and the social and economic climate of the communities in which they live.

"The increase in single parent and dual working-parent households is now a social and economic reality that compels greater attention to early childhood education and consequent enlargement of efforts such as Headstart.

"The limited growth of the size of our work force will be an even greater constraint on our economic development if we don't attend to the retraining of those whose jobs and skills and industries will become obsolete or overpopulated.

"Even if we eventually do the job of improving the educational development of our youngsters to a tolerable level of reading, writing, and mathematical comprehension, it will, in the meantime, leave displaced and alienated from the work force those who recently, and in the near term, miss(ed) the benefit of a functional educational experience. They will need remedial and developmental training in the skills required by the workplace or else remain an untapped resource, an economic burden and a potentially aggressive threat to society.

"The business community can do part of the retraining and remedial education job, but only the largest employers (who provide work for only a small portion of the national workforce) have the financial capacity to take on such an expensive task. It's easier for such employers, given their economic power to 'cream' the labor market wherever they can.

"Any thoughtful examination of our inner cities acknowledges the complex inter-relationships among the problems of jobs, family life, housing, and education.

Simply responding to these educational and training issues with a litany of recitals on the failure of the Great Society, CETA programs, etc., is not the leadership posture that is needed. We know TJTC and JTPA have worked. We know the cities need help. We know there is a building underclass.

"The president has to represent the larger constituency of the American people and the nation's welfare. Members of Congress have become increasingly preoccupied with the financial and voter support required for re-election, leaving few real leaders on either side of the aisle.

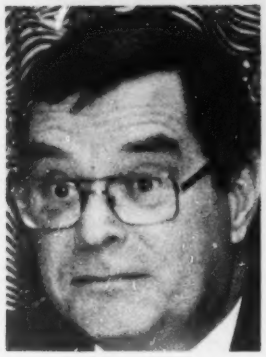
"It is necessary, I believe, for the president to take wisdom from our past attempts, enlarge upon efforts and programs that have worked and hold promise, begin to reorder our national priorities from wasteful defense expenditures (which do not advance our standard of living), and push for federal revenue generation that will, like enlightened trade policy, enhance our general economic development as a nation among nations in a global economy and provide funds for the protection and development of our human resources.

ElderCare. "Forty percent of workers over age 40 already provide care in some form to their parents. Nursing care costs are expected to rise from the $22,000 a year range to well over $50,000 in the next thirty years. Preoccupation with attention to elder members of their families is increasingly a source of anxiety and drain on the attention of employees, as reported frequently by human resources practitioners.

"Here again, remedies and programs for support and protection seem likely to come from a variety of sources including personal savings and insurance plans, corporate sponsorship of tax-protected funding mechanisms, more supportive and encouraging state regulatory and reimbursement systems for nursing care providers, and, finally, given the size of the problem, federal programs. All these efforts will be greatly helped by nationwide concern led by the president.

"In effect, the president must be encouraged to have us address the needs of those least equipped to do so themselves—our very young children,

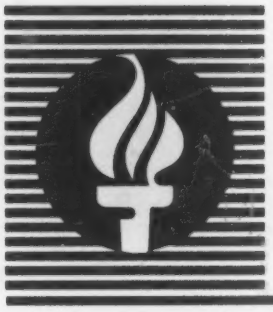
youngsters caught in the maelstrom of inner-city poverty and crime, those who despite their commitment and diligence find their jobs to have disappeared, and our elderly."



REX D. ADAMS
Vice President, Employee Relations
Mobil Oil Corporation
New York, New York

The theme that kept recurring throughout our day-long discussion was that of a major cleft in the United States. While most of the population is employed and comfortably middle income, if not wealthy, there is a growing part of our people who exist without economic participation, without family and community ties, without self-esteem, and without hope. Rex Adams described this condition as a "political malignancy," a failure of public investment in the face of private affluence. Perhaps it is an effect of the politics of self-interest carried to an extreme. One panel member, no liberal, said: "a little socialism might be a good thing for us now." The panel seemed to agree that protection of the most basic public amenities and investment in public improvement should be first on the new president's agenda.

R4105-29.82U
3/89



The Conference Board

U.S. Economic Outlook, 1989

Forum economists expect:

- *Ongoing expansion with GNP rise of 2.5%*
- *Major thrust from capital spending and exports*
- *Continuing support from consumer spending*
- *Some rise in inflation and interest rates*
- *Possible break in the budget impasse*

Research Bulletin No. 230

PARTICIPANTS

THE CONFERENCE BOARD ECONOMIC FORUM

January 13, 1989

ROBERT G. DEDERICK
Executive Vice President
and Chief Economist
The Northern Trust Company

ADRIAN T. DILLON
Assistant Treasurer
and Chief Economist
Eaton Corporation

EDGAR R. FIEDLER
Vice President and
Economic Counsellor
The Conference Board, Inc.

GAIL FOSLER
Deputy Staff Director
and Chief Economist
Senate Budget Committee

JONATHAN H. FRANCIS
Chief Economist
Rho Management Co., Inc.

JAMES GRANT
Editor
Grant's Interest Rate Observer

GEORGE H. HEYMAN, JR.
Advisory Director
Shearson Lehman Hutton

DONALD P. HILTY
Corporate Economist
Chrysler Corporation

JUDITH MAXWELL
Chairman
Economic Council of Canada

STEPHEN S. ROACH
Senior Economist
Morgan Stanley & Co., Inc.

ISABEL V. SAWHILL
Senior Fellow
The Urban Institute

ALLEN SINAI
Executive Vice President
Boston Company Economic
Advisors Inc.

JAY N. WOODWORTH
Vice President and
Domestic Economist
Bankers Trust Company

© 1989 The Conference Board, Inc.

THE CONFERENCE BOARD, INC.
845 Third Avenue, New York, N.Y. 10022
THE CONFERENCE BOARD OF CANADA
255 Smyth Road, Ottawa, Ontario, K1H-8M7, Canada
THE CONFERENCE BOARD, INC.
Avenue Louise, 207 Bte 5, B-1050 Brussels, Belgium
THE CONFERENCE BOARD, INC.
1755 Massachusetts Avenue, N.W., Suite 312, Washington, D.C. 20036

The Long Expansion: Still Alive and Full of Life

Edgar R. Fiedler

Members of The Conference Board's Economic Forum, convening for their winter meeting, found much common ground in their expectations about the direction of economic activity. On the inflationary and financial consequences, however, their projections revealed a range of small but significant differences.

The group was unanimous, or just next to it, in the view that the long business cycle expansion, now into its seventh year, is not only still alive but in fact full of life. The principal source of energy for the expansion is the industrial sector, which is being fueled from two main sources. The first is plant and equipment spending, which was up about 10 percent last year. This year, with both capacity utilization rates and profits high, business investment outlays should climb another 6 or 7 percent. Most of the increase will be in equipment, especially traditional industrial equipment. What gains are to be found in structures are also on the industrial side, that is, factories and warehouses. The overbuilt office-building sector continues to lag.

The second main source of strength is foreign trade, a direct result of the lower value of the dollar and continuing sturdy economic expansion abroad. At today's exchange rates, the United States is more than competitive in world markets. According to one calculation, U.S. producers enjoy a 26 percent advantage over their West German competitors and 35 percent over the Japanese. The extreme month-to-month volatility in the foreign trade statistics often obscures the trend, but in the Forum's view the trade deficit will continue to decline gradually, thus adding to U.S. output.

In the consumer area, several warning flags indicate that the rising trends of recent years will not go on forever. Nevertheless, although consumers are no longer the dominant propelling force in the economy, they still play a vital role in the continuing expansion. Surveys show consumer sentiment to be holding at high levels, suggesting that no change of direction is imminent and that Americans will continue to spend all but a small fraction of their current income.

Other major sectors of the economy are not moving dramatically either way. The housing market is going nowhere fast, and the same is true for spending by governments. Inventories do not appear to be a problem anywhere.

In summary, then, the thrust provided by capital goods and international trade, along with support from consumer demand, will move the economy forward nicely in 1989. How fast and how far this expansion will carry, however, is a matter of considerable uncertainty. One or two members of the Forum look for recession to begin as early as late 1989, but most put the next business cycle off until 1990 or 1991.

The severity of any cyclical downturn could be limited, moreover, by the favorable competitive position of U.S. producers. As long as the dollar stays near present levels, a significant part of any drop in domestic demand probably would be replaced fairly quickly by orders from abroad.

Edgar R. Fiedler

"A slowdown in growth is to be welcomed, not feared."

Although a recession is not expected for awhile, everyone is anticipating a slower pace of advance very soon. Under present circumstances, however, a slowdown should be looked upon not as a signal of economic weakness but as a necessity. With the economy operating at or near capacity, the speed limit for growth is about 2 or 2½ percent. Anything faster would exacerbate inflation. In addition, if the international deficit is to be cut, the growth of domestic demand must be reduced to make room for more exports. From the standpoint of long-term growth, furthermore, there is a need to reduce current consumption to allow for more investment. Under these conditions, a slowdown in growth is to be enthusiastically welcomed, not feared.

The Forum members are looking for slower growth, on average a modest slowdown to 2½ percent during 1989, roughly equal to the economic speed limit. The growth rate is thus the key to the outlook for inflation and interest rates. Special inflationary factors, such as oil prices, are not expected to have a major impact this year. On interest rates, the Federal Reserve appears to be targeted mainly on the economy. Consequently, whether inflation and interest rates head higher or lower depends almost wholly on how fast the economy advances. Anything faster than the speed limit threatens a further buildup of inflation and interest rate pressures; anything slower eases that threat.

Tranquil Markets

This seemingly minor difference—growth a little less than or a little more than 2½ percent—is more significant than it might seem. In 1988, despite the high operating rate, price and wage inflation accelerated only modestly, and long-term interest rates not at all. The reason, presumably, was that public expectations about inflation did not heat up. Financial markets have thus remained calm (more so perhaps than is consistent with the Forum's overall expectations).

Whether public confidence and the financial markets will remain tranquil through 1989 is, of course, uncertain. If the 1989 growth rate proves to be exactly 2½ percent, as forecast, it would presumably keep the economy poised on the borderline of overheating. The Forum consensus calls for inflation to creep up from 4.1 percent to 5 percent and the prime rate to hold steady all year at its present level of 10½ percent. Faster growth of the economy, however, would seriously heighten anxiety in the financial markets, which in turn would be manifested in higher interest rates, more inflation, and, perhaps, an earlier recession. Thus small differences in the pace of economic advance have the power to change the financial climate fairly dramatically.

An important part of the issue of financial confidence is the budget deficit and the possibilty that foreign investors will lose faith and in effect go on strike against the U.S. dollar. The chronic massive deficit is a central worry domestically, as well. There is concern that sooner or later it will lead to serious inflation and that it is preempting funds needed to finance the new capital investment on which future growth depends. The key to confidence in the financial markets, therefore, is whether the Bush administration and the Congress can break the stalemate of recent years and reduce the deficit in a timely and meaningful way. This is a formidable challenge, even more so when the costs of resolving the savings and loan crisis, rebuilding nuclear weapons facilities, and funding some of the President's campaign pledges are included. It is understandable, then, that the majority of the Forum's members is skeptical about achieving any significant improvement in the budget picture. Members look for the 1989 and 1990 deficits to remain near this year's $155 billion.

A few of us, however, see a fairly good possibility of a break in the budget impasse. It might come about through a difficult, confrontational process, in which sometime next September or October a compromise is forced by the "unthinkable" reality that the sequestration ax scheduled under Gramm-Rudman-Hollings will actually fall. Alternatively, a real closing of the budget gap could come about through statesmanship in the form of a negotiated 2-year deal in which each party relents on a key point. Thus the democrats might agree to cuts in social spending, and the president might agree either to a reduction in defense outlays in real terms or to a tax hike. The result, hopefully, would be a reliable expectation of lower deficits over the next few years. This would bring reassurance to the credit markets, a drop in interest rates, and an increase in the national saving rate with positive effects on long-term growth.

Although this prospect is not embraced by a majority of the Forum members, and although the possibility that statesmanship might prevail over stalemate in the budget wars is such an unusual thought that it seems almost bizarre, it is nevertheless a most encouraging note on which to close this summary.

The Forum Consensus
Results of a Pre-meeting Outlook Survey

		Projected		
	Estimated	1989		
	1988	Median	Range	1990
Economic Growth (Change in Real GNP)	2.7%	2.5%	1.0 – 3.3%	Slower
Inflation Rate (Change in GNP Deflator)	4.1	5.0	3.7 – 5.5	About the same
Corporate Profits (with IVA & CCA) (Change before taxes)	5.0	3.2	–3.0 – 9.5	Down
Unemployment Rate (Average during final quarter)	5.3	5.5	5.0 – 6.5	Up
Commercial Bank Prime Rate (Average during final quarter)	10.1	10.5	9.0 –12.0	Down
	FY 1988	FY 1989		FY 1990
Federal Budget Deficit (Billions of dollars)	155	158		159

Note: These forecasts incorporate submissions by Forum participants in early January, and are based on data available at the time. For growth, inflation and profits, the annual forecasts are the percentage change over the four quarters of the year, i.e., from 1988 IV to 1989 IV.

Approaching a Turning Point?

Allen Sinai

January marks the 74th month of the current business expansion, now the second longest upturn in the postwar period. As a cyclical matter, the record of this expansion has been extraordinary, given the momentous changes in fiscal and monetary policies, deregulation, the growing globalization of economies and financial markets, the decay and fluffing off of old business structures, big changes in the way U.S. business and financial institutions operate and the periodic crises—financial and otherwise—to which the U.S. economy has proved so resilient.

Why has the expansion lasted so long? One reason is that the great slack and unemployed resources at the start of the expansion created more room for expansion than at any other time in the postwar period. Second, fiscal policy, through massive reductions in general-income and corporate-profits taxes and continuing large structural budget deficits, has been stimulative, helping to propel the economy onward and upward.

Third, since 1982, monetary policy has operated periodically to retard the pace of expansion, postponing the day when the economy might reach full employment, generate an unacceptable inflation, and develop the imbalances that often lead to recessions. A rolling adjustment of sectoral and regional activities, tied to ebbs and flows of foreign trade in an increasingly open U.S. economy, also helped. Large segments of the economy actuallly were in recession during 1985-86, not enough to pull the overall economy down but enough to maintain lots of room for continuing expansion.

Fourth, inflation rates declined, on average, from 1982 to 1987 and with them, interest rates. Lower inflation and interest rates, along with the reductions in personal income taxes, helped sustain consumer spending at a strong pace throughout the period. Finally, the rest-of-the-world economies have been growing throughout, interacting more with the United States in a more global economic environment, in particular helping U.S. exports through an impulse of higher growth in 1987 and 1988.

In 1989 and 1990, the factors most responsible for the long and, particularly in the past year-and-a-half, quite strong expansion could prove decisive to its undoing. First, the great slack that helped inflation rates decline during the early and mid-1990's now has given way to a nearly fully employed economy with rising inflation. With the economy beginning to bump against capacity limitations and some labor shortages at existing wages, the pace of real economic growth must eventually slacken even as inflation can keep picking up.

Second, the stimulus of massive federal budget deficits, an essential element in the economy's strength over the past six years, remains; only that stimulus is a potential source of too-high inflation, too-large a supply of dollar-denominated debt for the dollar to be sustained at current levels, and a constraint on the Federal Reserve that prevents a lower profile of interest rates. Budget deficits are a big plus in an economy with unutilized resources, but a big negative when slack is gone and inflation is of concern. Viewed internationally, large budget deficits and the associated debt represent a possibility for yet higher inflation and a weaker dollar, longer run a negative fundamental for foreign investment in U.S. financial instruments.

Allen Sinai

"Headed for a major slowdown or perhaps even a recession."

Third, still large trade and current account deficits, although improving much in 1988 and a source of a welcome slowdown during 1985 and 1986, remain to push the dollar lower over the longer-run and as a source of upward pressure on interest rates to attract foreign funding. Fourth, the now rising rate of inflation as the by-product of an almost fully employed economy, acts to diminish real purchasing power and real wealth and ultimately to weaken the economy. Falling oil prices, which were beneficial through much of the earlier years in reducing inflation overall and helping to keep interest rates low, are no longer so. Now, crude oil prices are on the rise, up $3 to $5 a barrel, as OPEC cuts back on production and strong world economies push up the demand for oil and energy.

Fifth, Federal Reserve policy, a principal instrument used to enhance and sustain the expansion since 1982, must now turn more toward restraint than stimulus. The U.S. central bank cannot really tolerate existing inflation rates of 4½ percent and up and has been leaning against strong growth in the economy and high inflation for almost a year. To prevent a further acceleration of inflation requires a tighter monetary policy. This represents a sea change from early years, when monetary policy could be used to stimulate the economy without fear of too much inflation.

Slower Economy Ahead?

For the Federal Reserve, last year's "soft landing" strategy of modest doses of restriction to gently nudge economic growth and inflation lower, has not succeeded. Real growth

remains well above the central bank target of 2 percent to 2½ percent set for the second half of 1988 and inflation is running at 4½ percent instead of the targeted 4 percent. The Federal Reserve will be a source of restraint and a hindrance to the economy in 1989, with the unknown being how much and how fast short-term interest rates must be raised in order to limit economic growth and restrain inflation.

The economy should remain strong for much of 1989, showing 3 percent-plus gains (ex-drought) for another quarter or two. The unemployment rate can be expected to reach a low of 5 percent. But higher inflation in a 5 percent to 6 percent range and interest rates one-half to one-and-a-half percentage points higher will squeeze spending down some time later in the second half.

Late in 1989, or perhaps 1990, capacity limitations, high inflation, and higher interest rates will combine to slow the economy until it enters a major slowdown or perhaps even a recession. The central bank simply cannot tolerate the inflation currently in the system, not just because of domestic concerns but on international account where U.S. inflation rates are targeted at and actually performing far above the inflation rates in many of the major industrialized countries of the world. Too-high inflation relative to the rest of the world can only mean a declining dollar over time and yet higher inflation.

What is uncertain in the interim is the timing of a turning point and the path of inflation and interest rates, as well as the pattern for other parameters of performance. Also uncertain is the ability of the U.S. central bank to reduce real economic growth to a pace in line with potential growth and to stabilize and drive inflation rates down toward 4 percent instead of the current 4½ percent to 5 percent levels.

A lesson of history is that the economy tends to be stronger and resilient longer in the face of rising interest rates than might be expected, with inflation remaining entrenched until new slack is opened up. In similar situations, interest rates have most often tended to move higher for longer than expected, until enough financial strain combines with other forces to bite significantly into economic growth.

The Outlook for Canada

Judith Maxwell

Canada's medium-term prospects hinge to a greater degree than ever on developments in the global economy. Two global developments profoundly affected Canada in the 1980s. The first was the reversal of the commodity price boom, which coincided with the 1981-82 recession and forced a major restructuring in resource and manufacturing industries in Canada. The downturn in commodity prices put the brakes on the resource boom in Western Canada and forced a sharp rationalization of production, which in most cases led to gains in productivity. (Some sectors, such as coal, still suffer from weak prices and excess capacity.)

The net result of the fall in commodity prices was an abrupt acceleration in the long-term shift in employment from goods-producing industries to service industries. Many workers made a successful adjustment to new jobs. But some did not. The medium-term effect of the industrial restructuring has been much higher rates of unemployment in resource-dependent regions, like British Columbia, Quebec, and the Prairie provinces, than the rates prevailing in the early 1970s.

Widening disparities in unemployment rates have led to a considerable amount of regional tension in Canada. Even now as the economy is approaching capacity, the national unemployment rate is 7.6 percent (December, 1988), but this encompasses a rate of about 5 percent in Ontario and over 10 percent in British Columbia. Thus there are parts of Canada which do not now share the sense that the economy is approaching full utilization of its resources. There is opposition, therefore, to the cautious approach to monetary policy being pursued by the Bank of Canada in response to signs of selected shortages in some labor and product markets.

Judith Maxwell

"Global competition will be tough."

The Canadian economy in 1989 is clearly in the mature stages of a business expansion. So far, there are no internal signs of imbalances that would threaten the expansion,

although we do expect the pace of growth to slacken to 3 percent or less in order to parallel the rise in productive capacity. Indeed, even as the forces of expansion in housing and consumption begin to fade, new stimulus will kick in as a result of the implementation of the Canada-U.S. Free Trade Agreement this year. That agreement is expected to accelerate the current upswing in business-capital spending because firms will need to improve efficiency, or expand capacity, in order to compete in the wider market opened up by the agreement. This obviously means more restructuring, but also new opportunities.

The most immediate threats to Canadian expansion in the next couple of years will come from the external environment. The twin deficits of the United States and the overhang of less-developed-country debt could cause shifts in interest rates or exchange rates that could indirectly impact on Canada through slower growth in exports and more directly through the impact of higher interest rates on consumption and investment, and debt servicing by governments.

The second major event of the 1980s was the emergence of the United States as a major capital importer. This has provoked greater instability in financial and currency markets and accounted for new tensions in world trade. The shift to being a capital importer can be explained mainly by the macro policy setting in the United States in the 1980s. But it has forced an abrupt awakening in North America to the gradual shift in the locus of world economic power. I see this gradual shift not so much as an issue of U.S. decline, but of emerging strength of new competitors mainly in the Pacific Rim.

As the United States has become more open to international trade and capital flows, the overall outlook for interest rates and currency markets has become more strongly influenced by policy choices in the United States. Thus any moves on the part of the Bush administration to reduce the size of the federal fiscal deficit (and thus its dependence on foreign savings) would be viewed in Canada as a source of relative stability for the medium-term. It would make the environment in which Canada must deal with its own economic issues much more favorable.

The Challenges Ahead

On the domestic front, the sobering fact is that six years of growth have not solved all of Canada's economic problems. The two most important challenges ahead are the federal deficit and corporate competitiveness.

First, the federal fiscal deficit remains large for an economy that is approaching full utilization of its resources. The projections of the Economic Council of Canada for the medium-term performance of the economy indicate that, even in an environment of continuing but slower growth, the federal fiscal deficit will still amount to 3.5 to 4.0 percent of GDP by 1992. Until recently, the federal deficit was being financed primarily from domestic savings, but since private investment picked up momentum in 1986, Canada's dependence on foreign capital has increased to about 2.5 percent of gross domestic product.

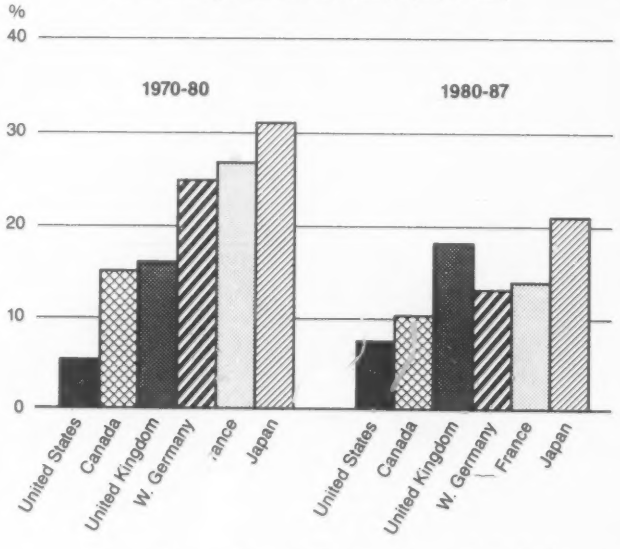
Thus, a very important policy priority for the next several years will be to alter the policy mix in Canada—adding more restraint on the fiscal side in order to free up room for the Bank of Canada to be more accommodating on the monetary side. The dilemma for Canada is that the federal government has more limited room for revenue increases than does the U.S. government and faces many of the same constraints on the expenditure side.

The other major issue Canada faces is competitiveness. The accompanying chart compares productivity gains in Canada and the United States with those in other industrial countries. Note that while Canada's productivity growth has exceeded that of the United States in both the 1970s and the 1980s, it has consistently fallen far short of that in other countries. And, of course, the emergence of vigorous competitors on the Pacific Rim is creating new challenges for Canadian producers, not only in the domestic market but in maintaining their share of third markets. A key element of the improvement in competitiveness will be finding the means to retrain and recycle the workers who are being affected by industrial restructuring. Thus, industry and government must make a much stronger commitment to investment in the training and formation of a skilled and flexible work force.

In summary, there is no denying the turbulence that Canadians will face in the next several years. Competition in the global market will be tough. In its decision to go ahead with the Canada-U.S. Trade Agreement, I think the Canadian public has signalled its readiness to venture forth with a new sense of confidence into this global marketplace. At the same time, there are many workers and trade union leaders in Canada who are extremely anxious about the restructuring that lies ahead.

Productivity Growth: An International Comparison 1970-80 and 1980-87

(Percent Change in Real GDP/Employed Person)



Recent work by the Economic Council of Canada, however, demonstrates that Canadians do have a remarkable capacity to adapt to new challenges. A highly disaggregated analysis of job turnover in Canadian manufacturing in the 1970s and 1980s shows that a remarkable amount of the growth in employment occurs as a result of the start-up of new firms. In effect, the differences in rates of growth in employment among industries are determined mainly by different rates of entry of new firms. The Council's analysis has also documented that worker turnover, that is, turnover initiated by employees, normally exceeds the amount initiated by employers. Not surprisingly, it also shows that restructuring is most successful for both workers and firms in an environment where economic growth continues. It was the sudden collapse of demand in 1981-1982 that made it so difficult for many Canadian workers to make an effective transition from one job to another in the 1980s. That is why the continuation of growth and the choices on U.S. policy in the next few months look so important to us Canadians.

Stalemate or Statesmanship?

Isabel V. Sawhill

After a year of relative calm in Washington following the 1987 budget agreement, the fiscal battles are about to start again in earnest. Gramm-Rudmann-Hollings requires a budget deficit of $100 billion for 1990, $30 billion to $40 billion lower than realistic estimates of the current services deficit for that year. Almost no one thinks it possible to achieve this level of savings without new revenues. And when one adds the costs of solving the savings-and-loan crisis, rebuilding nuclear-weapons facilities, and funding some of the new President's campaign pledges, the fiscal challenge appears even greater. Speculating on how this challenge will be met in a political environment where many of the key players are new is hazardous, but I see two possible scenarios for 1989: stalemate or statesmanship.

Isabel V. Sawhill

"Stalemate poses obvious risks."

The stalemate scenario calls for no budgetary action until August or September, at which point the need to raise the debt ceiling and the threat of sequestration under Gramm-Rudman-Hollings are likely to force a compromise between the White House and the Congress. By then, enough people will have forgotten George Bush's "read-my-lips" pledge to permit him to give in graciously to the inevitable tax increase. Higher taxes on alcohol, tobacco, and gasoline seem the most likely choices. These can parade as user fees for people who impose health, safety, and environmental costs on the rest of us. When combined with optimistic economic assumptions, some creative accounting, and spending cuts for Medicare, farm subsidies, and a host of smaller programs, they would permit a downpayment to be made on the deficit, which like the 1987 agreement, would probably cover two years, 1990 and 1991. This downpayment would buy political time for the new administration to formulate a longer term strategy combining elements of deficit reduction and structural reform.

The longer term package would have to address a number of major issues, such as: (1) whether to amend Gramm-Rudman-Hollings; (2) whether to continue to use Social Security surpluses to offset operating deficits that will still equal 4 percent of GNP by 1993; (3) whether to take on the politically difficult task of restraining entitlements which are, next to interest, the most rapidly growing segment of the budget; (4) what kind of restructuring of the defense budget is possible in the light of new arms-control initiatives or burden-sharing agreements with our allies; and (5) whether a new revenue source, such as a value-added tax, is needed.

The stalemate scenario poses some obvious risks to the economy. Financial markets at home and abroad have been expecting a new administration to act decisively and could react adversely to continued squabbling through most of 1989. A "dollar strike" that sent interest rates to new highs or stock prices to new lows could provide added impetus for action in Washington; but it might also trigger a recession, producing a quandary for the Federal Reserve, which would have to choose between moderating the recession and shoring up the value of the dollar. Even without a dollar strike—not a highly likely occurrence—the failure to reduce the deficit leaves no room in a full-employment economy for a noninflationary expansion of exports in response to earlier declines in the dol-

lar. Any overheating for this reason would leave the Fed no choice but to drive up interest rates if it want to preserve Mr. Volcker's hard-won gains against inflation. Because the new economic team of Brady, Darman, and Boskin is well aware of these risks, and because the fiscalization of virtually every policy issue would hamper the success of the new administration from the very start, some Bush advisors are bound to argue for an aggressive effort to forge a serious deficit compromise early in 1989, leading potentially to a very different scenario.

In this second, more statesmanlike scenario, I see the new President, or his designees, meeting privately with the leaders of Congress to negotiate a bipartisan package. If this courtship is to end in marriage, the new President would have to give up his tax virginity early. Obviously, neither side would be entirely happy with the compromise, but each would privately swallow a bitter pill in the interests of the nation as a whole. For Mr. Bush the bitter pill might be a hefty increase in energy taxes, which is gaining support on Capitol Hill. For the Democrats, it might be reductions in Social Security COLAs or greater taxation of Social Security benefits, which many are now willing to endorse in private. The compromise could include enough sweeteners—for example, new investment incentives or increased spending on a kinder, gentler nation—to make it politically palatable to a wide variety of groups. Ideally, it would be a multiyear package that would calm markets, lower interest rates, and enable the country to hold its head high again in international circles. Perhaps this second scenario is wishful thinking, but George Bush is no Ronald Reagan and I have a sneaking suspicion that he will not want to leave the deficit monster roaming the countryside to damage both the economy and his presidency.

Setting the Stage for a Hard Landing

Robert G. Dederick

When considering monetary policy and its implications, several issues merit attention. I address them here in a question-and-answer format.

Q. *What is the Federal Reserve's primary objective?*

A. The same as it has been for the past several years—to achieve "noninflationary" growth in the United States—that is, to avoid recession and contain inflation at the same time—that is, to walk the narrow path between too much ease and too much restraint.

Q. *What does "noninflation" mean?*

A. A rate of increase in the consumer price index of 4 to 4½ percent, that is, something in line with the core rate throughout this business expansion. There is no intention to seek a lower inflation rate this time around, since to do so would threaten growth itself.

Q. *What does "noninflationary growth" mean?*

A. Under current circumstances, something close to the full-employment expansion path, that is, about 2 to 2½ percent growth.

Q. *How is the Fed's objective to be achieved?*

A. By a) leaning against the wind, as in the William McChesney Martin days; but,

Robert G. Dederick
"Once again, the firm smack of policy."

b) in contrast with the Martin days, leaning against the breeze, too; and

c) also in contrast with the Martin days, staying ahead of the breeze (now known as the "curve"), whichever direction it is headed—toward more inflation or toward sluggish to negative growth.

Put differently, by pre-emptive fine-tuning.

Q. *Why are they using pre-emptive fine-tuning?*

A. For several reasons: First, there is fear, in contrast with the 1950s and the 1960s, that a recession, once underway, might become severe. Second, that fine tuning, taken alone, will fail as it did in the late 'seventies. Third, there

is the confidence of the Greenspan-led Fed, in its ability to forecast; neither the Martin Fed nor the Volcker Fed had such faith in its own powers. Finally, the economic atmosphere is different; in contrast with most (but not all) of the Volcker era, there is at present no problem serious enough to deserve overwhelming emphasis—and, thus, no problem serious enough to permit gross tuning.

Q. *In making policy today, does the Fed give weight to any special factors?*

A. Yes—several. One is the course of the dollar exchange rate—but only to the extent that it affects the achievement of the Fed's primary objective. The Fed is not concerned with the dollar's level per se.

The viability of LDC debtors is another, and the viability of savings and loan institutions, and of leveraged-up corporations. Also, some Fed members desire not to "disrupt the urgent task of reducing the federal budget deficit."

Q. *Will the Fed, in fact, achieve its objective?*

A. I doubt it. It is not difficult to keep inflation in check when operating below the full-employment ceiling. But it is extremely difficult to do so when operating at the ceiling—even if growth is held to the full-employment path. Achievement of the Fed's growth target under such circumstances almost certainly implies a worsening of inflation, even if gradual. And, given the Fed's stated concern about a "marked weakening in the economy" the risks are slanted in favor of permitting too strong an economy, that is, a growth pace in excess of the full-employment path. Put differently, the current fear of overdoing it is likely, ultimately, to leave the Fed in a position where it will be forced to overdo it.

Q. *What comes next?*

A. In the near future, more of what we have been seeing to date, that is, further probing moves designed to enforce the speed limit. Like the rest of us, the Fed is responding to the incoming stream of economic data. And, if my forecast is correct, in the quarters ahead those economic data, on balance, will continue to come in stronger than the Fed desires; just as it did in 1988, growth will exceed the posted speed limit. Inflation, in consequence, will worsen, probably at a gradually accelerating pace. In further consequence, the Fed will keep boosting the Fed funds rate periodically. Other short rates will rise in tandem, and—once the market comes to realize that the anti-inflation aspect of the Fed's objective has been compromised—long rates will rise as well, albeit more sedately. The yield curve will both elevate and become more inverted.

Q. *What comes thereafter?*

A. Recession avoidance will slide in importance relative to inflation control, thereby setting the stage for a hard landing. The key variable will be the Fed's inflation tolerance level. And that, in turn—since the Fed, ever mindful of its independence, is a follower rather than a leader—will depend on the public's inflation tolerance level. When the flash point is exceeded, fine tuning once again will give way to the firm smack of policy. Interest rates, and then the economy, will react accordingly.

Q. *When will the business correction occur? And how much higher will interest rates rise in the interim?*

A. At a guess, by late 1989 or early 1990—with short rates perhaps 1½ pecentage points higher than at present and long rates up about half as much. But, to repeat, that is just a guess. If it is wrong, chances are that the timing will be later and the interest-rate climb will be larger—perhaps considerably so.

The Budget Debate: Shear Madness

Gail Fosler

Future prospects for the nation's budget deficit evoke reactions from even hardened analysts, ranging from intense concern to hand-waving hysteria. Like the other long-running play in Washington these days, "Shear Madness," the outcome in this year's budget debate is anyone's guess.

In the end, the Congress will have to vote on the outcome. The following is only one view, and not necessarily a consensus view of what that outcome will be.

Over the past two weeks, the administration and the Congressional Budget Office both have released their estimates of the five-year budget outlook under current policies. The administration's estimates show—not unexpectedly—that the deficit virtually vanishes with no change in policy.

By contrast, the Congressional Budget Office (CBO) estimates show the budget deficit declining from $141 billion in fiscal 1990 to $129 billion in fiscal 1993. At issue is whether either of these estimates represents a credible deficit path given the likely course of the economy and important problems—like the savings and loan crisis—that must be solved in the new administration.

Even with the large differences between the CBO and administration forecasts, the principal differences between the CBO's and the administration's baseline budget estimates are not economic, at least through fiscal 1990. Despite its higher real growth forecast, the administration's revenue estimate is lower than the CBO's in both fiscal 1989 and fiscal 1990. Indeed, both baseline forecasts contain inconsistencies that, if resolved, would tend to cause CBO and the administration's fiscal 1990 baseline deficits to converge in the $130 billion range.

The prospects for a budget agreement are much more favorable than generally recognized. While the administration's baseline forecast is likely to be adjusted by Congress to reflect consensus assumptions in several areas, the result is still likely to require a cut of $30 billion to meet the 1990 Gramm-Rudman-Hollings target ($100 billion).

Gail Fosler

"Long term, higher national savings are required."

No one should expect that the President-elect means anything other than what his lips have said—no new taxes. President Reagan's budget proposes an array of spending cuts that total $36.5 billion in fiscal 1990. This is a wide ranging menu from which Congress will eventually have to chose significant savings in both discretionary and entitlement programs. The President-elect may contribute a willingness to compromise on defense spending.

A final budget agreement is likely to take the form of a two-year agreement, with additional savings in the second year to reach the fiscal 1991 deficit target, and with the savings-and-loan rescue considered separately from the Gramm-Rudman-Hollings targets.

Let me add that these observations are based not on knowledge of current discussions within the policy process itself, but on my personal judgments of an outcome that would be reasonable and likely. My conclusion is that the federal budget deficit, excluding the savings-and-loan issue, will decline to close to $100 billion as we move through fiscal 1990 and will be well below $100 billion in fiscal 1991—whether deficit reduction is achieved through a budget package or through the across-the-board cuts in Gramm-Rudman-Hollings.

THE FEDERAL BUDGET
OMB AND CBO CURRENT SERVICES ESTIMATES

($ billions)

	FY1990	FY1991	FY1992	FY1993
Outlays				
OMB	1,184	1,238	1,278	1,315
CBO	1,209	1,280	1,344	1,410
Revenues				
OMB	1,058	1,137	1,209	1,278
CBO	1,069	1,140	1,209	1,280
Deficit				
OMB	–127	–102	–70	–37
CBO	–141	–140	–135	–129

Longer Term Implications

The effect of the budget on the economic outlook is determined not just by the stimulus from the size of the deficit, by but by its impact on credit markets and on the long-term growth prospects for the economy. Long-term savings and investment considerations are increasingly prominent, and rightfully so, in the policy discussion. Budget deficits also have long-run implications for the level of national savings and growth in the capital stock.

Early in the next century, labor force growth will slow in the United States (as well as in other industrial countries).

Without additional growth in the capital stock, the growth in the nation's living standards is also likely to slow. This suggests that, in addition to its near-term economic implications, budget policy has an important long-run structural dimension.

Under the CBO baseline, fiscal policy becomes increasing restrictive over the next five years. Although the CBO estimates suggest that fiscal 1989 is mildly stimulative, this is due largely to the increase in outlays to rescue failing thrift institutions. This hardly represents the same type of stimulus as the traditional transfer payment.

Indeed, the $150-160 billion deficit expected in fiscal 1989 may be far less stimulative than it appears, because of the impact of tax reform on high-income consumers. Of course, with additional policy action, fiscal policy will be even more restrictive than the baseline estimates.

Moreover, federal borrowing requirements are likely to continue to decline—even with the resolution of the savings-and-loan crisis. Again, under the CBO baseline, federal borrowing from the public declines from $162 billion in fiscal 1988 to $139 billion in fiscal 1989 and remains in the $130-$140 billion range through fiscal 1993. With $30 billion of deficit reduction in fiscal 1990 and more than $30 billion likely in fiscal 1991, federal borrowing requirements would continue to decline significantly for the foreseeable future.

It should be emphasized that these estimates already include substantial disbursements for the thrift crisis. It may be that the final resolution of this crisis will be more costly than already assumed, but not so much more so as to alter these conclusions.

For the near-term, trends in fiscal policy strongly point to lower interest rates. This, in itself, will further improve the budget-deficit outlook. Over the longer term, the key economic policy problem remains one of national savings. It is clear that balancing the federal budget will put the federal government out of the business of dissaving.

But this balancing does not address the need for private savings to rise. The private savings rate is currently going up—which is an encouraging sign. However, over the long term, the nation requires a somewhat higher national savings than so far during the decade of the 1980s, in order to be able to maintain the investment growth in recent years. There is even an argument, as yet untested empirically, that investment growth needs to rise significantly in the next century. It will be this broader debate over national savings and long-run growth that is likely to dominate policy decisions in the years to come.

How Do We Finance The Current Account?

Jonathan H. Francis

In early 1989, as a year ago, the U.S. external deficit is perhaps the greatest perceived threat to the otherwise sanguine views of business economists for the next 18 months. While it is generally understood that the external deficit itself need not imply a threat to the economy, at least in the short term, it is not generally understood how the deficit is to be financed. Therein lies the perceived threat. For the deficit will indeed be financed, but if it is to be on terms similar to those of October 1987 when bond and equity prices dropped sharply, economists would likely be less sanguine.

The uncertainty about the financing continues despite considerable improvement in the deficit through mid-1988. The U.S. nominal net export deficit hit bottom in the third quarter of 1986 and has improved by almost 20 percent per year since then. The trough for real net exports came in the third quarter of 1987 and a year later the deficit stood 36 percent lower!

However, the International Monetary Fund (IMF) forecasts little further reduction of the external imbalances of the United States, Japan, and West Germany in 1989, and projections done by the Brookings Institution suggest a wider U.S. deficit in the medium term. Economists are concerned that the strains of financing the continued deficit may lead to a sharp rise in interest rates and threaten the outlook.

Jonathan H. Francis

"At current exchange rates, the United States is quite competitive."

CURRENT ACCOUNT PROJECTIONS

($ billions)

	1988	1989	1990	1991
United States	–129	–129	–162	–185
West Germany	45	42		
Japan	78	81		

Sources: *World Economic Outlook*. International Monetary Fund, Washington D.C., October 1988; *External Deficits And The Dollar*, The Brookings Institution, Washington D.C., 1988.

Shifting patterns of international finance lend some support to this view. Typically, financig the U.S. current account deficit has not been a problem. Since 1973, private capital flows financed 140 percent of the current-account position, except in 1987 when much of the central bank purchases of dollars was camouflaged as bank-related inflows. By mid-1988, however, private inflows were more than sufficient to finance the current-account deficit.

Flows of net private capital have three major components—net direct investment, net transactions in securities, and net bank related transactions. (A fourth, net nonbank related transactions is unimportant). It is the balance of foreign purchases of U.S. stocks and bonds and U.S. purchases of foreign stocks and bonds that accounts for the bulk of the net private capital flows. Bank-related transactions also play an important role. Direct investment is of little importance.

This has not always been the case. In 1973-79 net direct investment had accounted for a 70 percent share of private capital inflows to the United States. By 1987-88 this share had declined to 15 percent. Net securities transactions had a 15 percent share in 1973-79 and rose to well over 50 percent in 1987-88. This shift in the composition of the private-capital inflows was accompanied by a sixfold increase in their volatility.

The rising share of portfolio investment and bank-related transactions, at the expense of direct investment, in the finance of the current-account deficit is consistent with economists' views of a world capital market that is imperfectly integrated. As a 1987 IMF *Staff Paper* put it, "That national markets for some types of financial capital (securities) are integrated may be irrelevant in evaluating the degree of integration of national markets for physical capital. We do not know why the apparent isolation of national markets for physical capital has persisted in the face of substantial expansion of trade in goods and services and in financial capital."

One of the consequences of this imperfect integration of world capital markets may be the increased volatility of international flows of financial capital, and of the ingredients of the prices associated with these instruments, interest rates and exchange rates. Therefore one way of viewing the perceived risks to the U.S. economic outlook is as reflecting the strains of a slowly moving process of integration.

One measure of how great that strain may have become is shown in the table below. The estimates of purchasing-power-parity (PPP) exchange rates reflect the competitive positions of the United States versus Japan and West Germany in internationally traded goods. At current exchange rates the United States is quite competitive. If the terms of trade for the United States (the ratio of U.S. export prices to U.S. import prices) had declined with the dollar, the current account deficit would likely be lower and one could be hopeful of eventual re-equilibration in the traditional manner. However, foreign exporters have dropped their prices to offset the rise of their currencies and short-circuited this process.

There may be another potential route by which the move to equilibrium will continue. The improved competitive position of the United States may attract a surge of foreign direct investment. It is very attractive to finance the creation or the expansion of U.S. business operations by raising funds in foreign markets. At the end of 1988, when the yen, say, was at 120 yen per dollar one could have financed a capital expansion in the United States at some 320 basis points below costs in U.S. markets for 10-year money. Given that kind of spread, the dollar would have had to fall to about 90 yen for the cost advantage to have been eliminated—a further dollar depreciation of 25 percent, about what the devaluationists expect. If, instead, one were to bet that the dollar would return to levels consistent with PPP over a ten-year period, then it would require the dollar to rise to around 150 yen to yield a cost-free investment and anything above that would represent a negative cost to the transaction.

In essence, this amounts to the kind of one-way bet that may end the "isolation" of the U.S. market for physical capital. The increased investment would create the additional capacity to displace imports and move the trade accounts back towards equilibrium even if foreign exporters continue to price to try to maintain market share. In the process, the share of direct investment in the finance of the U.S. current account may rise and eliminate some of the volatility in financial markets. However, the surge of net direct investment has not emerged to date and until it does the economic outlook will be held hostage by the perceptions of international portfolio investors.

DOLLAR EXCHANGE RATES

	YEN	DEUTSCHEMARK
Current Exchange Rates (Mid-January 1989)	126	1.82
Purchasing Power Parity Consistent Exchange Rates	193	2.47
Percent Difference	–35%	–26%

Source: *The International Economic Analyst*, Goldman Sachs International Limited, London, December 1988.

Inflation: No End in Sight

Jay N. Woodworth

Inflation is speeding up once again and seems headed for a rise of 5 to 5.5 percent during 1989. The annualized inflation rate during the first quarter alone will probably exceed 5.5 percent. These numbers should come as no great surprise to the financial markets.

But a further buildup of worldwide inflation pressures and the continuing absence of a recession in the United States would cause the inflation rate to speed up still more—probably to more than 6 percent—during 1990. No end to the current inflation cycle is in sight; it will take a moderately severe recession in the United States, Canada, and Europe to do the job and *nobody* is now talking about this scenario.

The likelihood of higher inflation rates beyond 1989 has not yet dawned on the financial markets. The markets have assumed that the economic expansion is very close to an end and, thus, inflation and interest rates will fall back during a downturn. This assumption is proving false. Interest rates will rise as the markets realize that inflation has much further to go—with a hike in short-term rates now, long-term rates somewhat later.

Jay N. Woodworth

"Last year, price inflation accelerated in all seven nations.

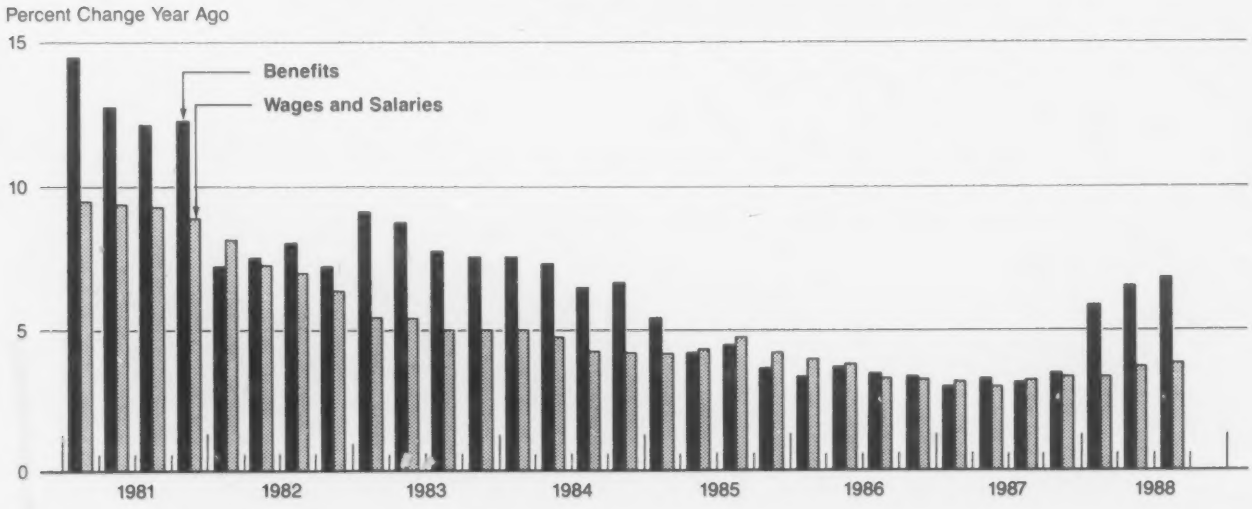
Roots of Higher Inflation Rates

After six years of economic expansion, it is remarkable that the U.S. inflation rate during 1988 was "only" 4.5 percent. While this performance seems "moderate" by the standards of the past twenty years, a 4.5 percent rise in prices is quite rapid in the long view of American economic history. To date in this expansion, though, inflation has been held down by a combination of unusually stiff competition from imported goods (coupled with a high value of the U.S. dollar from 1982-85), lower basic commodity prices (especially of energy goods), comparatively slack labor market conditions (until recently), and abundant harvests worldwide (despite last year's drought in the United States.

Nonetheless, a number of forces are working to boost inflation rates—not just in the United States but throughout the industrialized world. Last year, price inflation (measured by the CPI) accelerated in all of the group-of-seven industrialized nations, as rising raw-materials and labor costs staged a general acceleration. In two countries, Japan and West Germany, the 1988 inflation rates are comically low by the U.S. standards, but both take their 1.2 and 2.2 percent (respectively) inflation very seriously.

The speedup of inflation is thus becoming a worldwide

Wages Are Rising Slowly But Benefits Are Surging



phenomenon. The solution to it is also a cross-border process that will take time—and probably extra-high interest rates.

A large part of the acceleration in price increases has been due to higher raw materials prices—even before the latest round of firming of oil prices. The explosive growth in 1987-88 in the CRB Raw Materials index has foreshadowed a similar bulge in the crude materials index of the Producer Price Index, the fastest run-up since 1981. In this cycle, however, there appears to have been a smaller pass-through of higher crude-materials prices into intermediate and finished goods prices. Nonfood, nonenergy intermediate goods prices have risen recently at 7.5 percent annual rates and finished goods prices are up at a 5 percent annual pace, but both sets of figures trail well below their corresponding 1978-81 price increases.

There is also evidence that capacity shortages in selected industries are putting pressure on finished goods prices. Prices have risen by 8 to 11 percent in several basic industries (chemicals, primary metals, paper and rubber and plastic) where capacity utilization rates are the highest. Prices have barely increased elsewhere in the manufacturing sector (electrical machinery and food and beverages) where utilization rates are well below average.

Finally, labor compensation costs—especially benefit costs—are rising powerfully for the first time in this cycle. The chart shows the doubling in wage rate increases for production workers in manufacturing industries in the past two years. While the current 4.5 percent pace of increases is well below the 8 to 9 percent figures from the late 1970s, a further tightening in labor market conditions will likely cause a further acceleration. The turnaround—to a 7 percent pace—in fringe benefit costs has been even more noticeable. The compensation cost increases are placing modest upward pressure on unit labor costs, though most of the potential damage has been offset—thus far—by the outsized gains in productivity in the manufacturing sector.

An eventual economic slowdown (or recession) will almost certainly erase the productivity gains, causing unit labor costs to rise during the slowdown. The real key to the behavior of the inflation rate is the "therapy" that a recession would produce: easing capacity constraints and cost pressures in industry, reducing wage demands, generating more competitive pressures on prices and margins. Without the therapeutic effects of a recession, it is hard to see a lower inflation rate.

Also, past recessions in the United States have usually been "exported" to Canada and Western Europe, a process that has reduced inflation rates throughout the West. No such replay is in sight this time. Inflation may well continue to accelerate for the next several years.

Investment And Inventories

Adrian T. Dillon

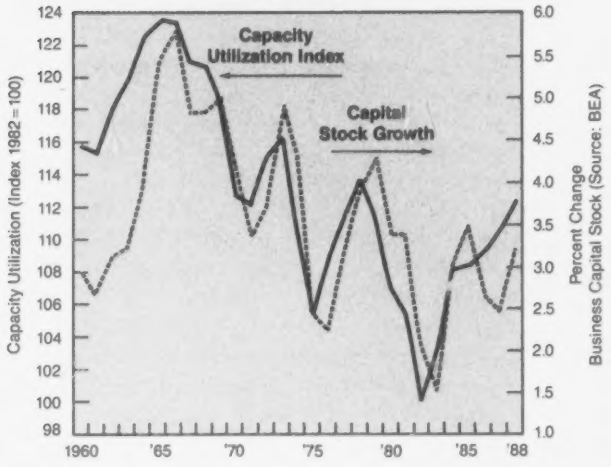
The year 1989 should be another good one for investment, particularly for domestic manufacturers of capital equipment. After a 10 percent rise in fixed investment during 1988, capital spending should rise another 6 percent to 7 percent this year. As in 1988, the strength in spending this year will be concentrated in equipment; nonresidential structures should show very little growth after declining in 1988, while equipment purchases should be up about 8 percent following 1988's 14 percent advance. In contrast with 1988 and, indeed, the entire expansion to date, the strength in equipment spending this year should be in industrial equipment rather than "high-tech" goods. Finally, inventories remain in excellent shape virtually across the board. With the pace of the expansion slowing this year, inventories will not be a source of strength to the economy, but the excellent control of inventories seen today will help prevent a slowdown in the pace of the expansion from turning into an inventory-led recession.

Adrian T. Dillon

"Actual capital spending will again exceed early expectations."

As always, the outlook for capital spending depends critically on the overall conomic outlook; as the chart shows, the desire to add to the nation's stock of capital is heavily influenced by recent rates of capacity utilization. Fortunately, the overall expansion, now into its seventh year, shows no signs of faltering. Rather, we expect the pace of the expansion to moderate from the 4 percent growth in *nonfarm* GNP during 1988 to 2½ percent to3 percent this year. Consumer spending is expected to show only a 2½ percent rise, while housing should be down again, to 1.40 million starts from 1988's 1.48 million. But the structural improvement in trade, while slow-

Total Business Capacity Utilization Index and the Growth Rate of Business Capital Stock 1960 to 1988



ing from the blistering pace of 1987-1988, remains intact: export growth should slow to "only" 9 percent this year from the 18 percent gain in 1988, while import growth should also be halved to a 4 percent gain. Thus, manufacturing will continue to be the source of the economy's strength this year, with industrial production rising 4 percent after 1988's 6 percent increase. Perhaps the best news is that, with the pace of the expansion expected to slow to the "sustainable rate" desired by the Federal Reserve, there is no reason to believe there is a recession on the forecast horizon.

Given current high rates of capacity utilization, it is not surprising that the first surveys of 1989 capital spending plans—by Bureau of the Census and McGraw Hill—report that business firms plan to increase spending this year by about 6 percent. Indeed, as has occurred for the past two years, actual spending is likely to exceed early expectations as the expansion proves more resilient than expected and forecasts of imminent recession recede again. One suggestion implicit in the surveys that should be explicitly ignored is a reported decline in spending plans for the second half of the year: For at least the third year running, spending surveys have reported dramatic increases in planned first half spending and outright declines in the second half. Actual spending has shown more modest gains in the first half and *continued* increases in the second half, a pattern that should be repeated this year.

Equipment Spending

Strength in capital equipment spending over the course of the 1980s has been concentrated in "high-tech" goods: computers, word processors, telecommunications equipment, and instrumentation. Real purchases of information equipment have nearly tripled since 1980 while purchases of other categories of equipment—transportation, industrial, and other equipment—remain essentially where they began the decade, despite the recent gains.

The secular rise in information-processing equipment is not surprising given the ongoing revolution in computing technology that has driven prices of this equipment down 7 percent annually for the past decade. This category of goods has also been aided by the fact that about 80 percent of information processing equipment purchases are made by the services sector—by far the fastest growing sector of the economy in the 1980s.

But the "sea change" we see in the overall economy—away from consumption, construction, and services and toward manufacturing and trade—is beginning to affect equipment purchases as well. Orders for office and computing machinery have been weak lately and, after an 18 percent rise in purchases in 1988, information-processing equipment should rise "only" 8 percent this year. On the other hand, another double-digit increase in industrial-equipment purchases is expected this year after the 11 percent rise in 1988, making it the fastest growing category of equipment spending during 1989. Transportation-equipment purchases will also have another very good year: aircraft deliveries will accelerate this year and heavy truck purchases, which are extremely sensitive to the pace of industrial activity, will be up about 5 percent, after 1988's 13 percent rise. Business purchases of autos and light trucks, on the other hand, should be flat this year, bringing the total rise in transportation-equipment purchases in 1989 to about 7 percent, after 1988's 15 percent advance.

Domestic manufacturers of capital equipment saw their own sea change last year: U.S. shipments of (non-auto) capital equipment exceeded U.S. purchases—17 percent versus 13 percent—for the first time in the 1980s. Given the continued turnaround in trade and the fact that capital goods is the largest category of both imports and exports in merchandise trade, manufacturers shipments should exceed purchases again this year, up 12 percent versus an 8 percent rise in purchases.

Nonresidential Structures and Inventories

The outlook for total nonresidential structures can be summed up succinctly: more of same. After falling 6 percent in 1987 and 2 percent in 1988, investment in nonresidential structures during 1989 will be flat at best. Below this aggregate, however, a shift in strength is occurring. Office construction, plagued by continued overcapacity resulting from the boom in the first half of the decade, remains very weak, with contracts for new construction continuing to fall through year-end 1988. Store construction, tied to housing completions, has been steadier but weakening. But industrial construction, which never recovered during the boom of the early 1980s and fell again in 1986-1987 because of the Tax Reform Act of 1986, is finally beginning to recover. Spending rose sharply in the second half of 1988 and should be up to a 10 percent rate over the course of 1989 as manufacturing continues to contribute disportionately to the nation's overall growth.

The inventory outlook can also be summed up succinctly: Virtually across the board, businesses have kept extraordinary control over inventories during this expansion. Unless final sales collapse, inventories will not be a source of weakness in the economy over the course of 1989.

Consumer Spending and Housing

Donald P. Hilty

A large portion of the uncertainty about the economic outlook represents question about economic policy. What changes can we expect from the new administration? Some believe recent U.S. prosperity has been based on high consumer and corporate leverage, depression-level federal budget deficits, and record trade deficits—and thus dramatic changes are now needed to avoid an interest-rate or exchange-rate shock. Others believe the Roman Holiday can go on indefinitely.

Because of this great uncertainty, I think it is prudent to identify the possible scenarios and watch carefully which path the economy seems to be on.

Donald P. Hilty

"A consumer spending pause is not yet on the horizon."

Forecast Scenarios For 1989 and 1990

	Probability
Strong growth	.10
Slower, but sustained growth	.60
Mild recession	.25
Shock	.05

Many components of consumer spending, such as autos and housing, fluctuate wider and often lead fluctuations in general business activity. So some companies have developed specific leading indicators for their individual industries. Paying attention to these leading indicators is especially important now with the heightened uncertainty. Chrysler Corporation's auto industry composite indicator is on cautionary yellow.

Auto Industry Leading Indicators

	Current Status
Installment debt	Red
Interest rates	Red
Consumer attitudes	Yellow
Price pressures	Yellow
Disposable income	Yellow
Workweek	Yellow
Unemployment claims	Green
Stock market	Yellow
Composite	Yellow

These indicators are listed in order of reliability based on Chrysler's analysis of post-World-War-II cycles. It is sobering that the most reliable—installment debt and interest rates—are on red.

Research also suggests that the probability of an auto industry decline reaches .5 when real GNP growth slows to a seasonally adjusted annual rate of 2.5%. (The Blue Chip average GNP forecast is 2.7 percent for 1989, 1.7 percent for 1990.)

In past cycles when auto sales peaked, they fell quite rapidly. Not so now. Auto sales peaked in mid 1986. The sales rate has been easing, but not precipitously.

Pent-up demand from the great recession of 1980-82 was satisfied at least a year ago. The auto industry has bolstered sales with innovative incentives. Sales performance is still traveling at an annual rate of about ½ million units above the long-term trend. How long will this last? In this economic setting, basically "middle-of-the-pack" assumptions seem prudent. That is what the "Big Three" automobile companies are doing; each is forecasting 1989 auto sales at 10.0 to 10.2 million units and truck sales at 5.1 to 5.2 million.

Contingency planning also seems especially important nowadays. In a moderate downturn, auto sales probably would drop 10 percent below trend, in a severe downturn 20 percent. Of course, the segmentation mix would weaken. The small car share of the market could rise 3 percentage points in a severe downturn.

Housing activity—especially in California and Florida, where one-third of total U.S. starts occurred in 1988—shows no sign of weakening. Starts, permits, and sales have all remained steady for the past six months or so. Average outlays for new homes have risen by close to twice the rate of inflation; much of this rise was the result of a richer mix.

Mortgage rates have not climbed much and show few signs yet of rising enough to choke off starts. As long-term interest rates continue rising, however, mortgage rates should follow, reducing the level of housing starts from 1.47 million in 1988 to about 1.40 million this year.

Consumer spending for services and nondurables should slow somewhat in the next year and a half as the effects of higher interest rates, a weaker employment picture, and slower income growth take their toll. Incomes and finances of consumers were boosted by lower tax rates and continued strong employment growth last year. This assist will not be available in 1989. But a consumer spending pause is not yet on the horizon.

The Debt Threat

James Grant

Michael Milken, the Alexander Graham Bell of corporate leverage, is having his troubles, but debt has never been more respectable. Of recent vintage are the Sotheby's art-equity loan, the 40-year residential mortgage loan, and the five-year Yugo automobile loan. In the shank of the Reagan prosperity, there have been record bank failures and an epidemic of "thrift" failures. Corporate equity capital has shrunk and corporate debt has bulged. Ironically, Milken has never been nearer the center of the financial establishment than he is in the hour of his legal crisis.

Is there too much debt in America? I submit that there is, although I am skeptical of the usual macroeconomic evidence. Probably everyone has seen the alarming-looking graph of nonfinancial debt as a percentage of GNP. From 1960 to 1980, the number hung in the neighborhood of 130 percent. In 1982, it began to take off and it has has hardly looked back. At last report, it stood at 179 percent. With its long back and jutting neck, the graph looks exactly like the Loch Ness monster is supposed to look. And I suppose that, over the past few decades, there has been reason enough to doubt that the debt monster was any more real than Nessie. Back in 1955 (when the ratio of debt to GNP was a mild 125 percent) economists warned against what seemed a ominous deterioration in the quality of debt. One may remember, however, that there was no debt smash-up in 1956, 1957, or any year thereafter.

The financial story of the 20th century, it must be admitted, is the relaxation of lending standards. A.P. Giannini's faith in the creditworthiness of the working man at the turn of the century paid big dividends at what became BankAmerica. It was in a forward-looking, progressive spirit that the Federal Reserve System was created in 1913, that automobile-installment credit was made available in the 1920s, and that a federally guaranteed home-mortgage market was developed in the 1930s. In the mid-1970s, the democrats at Drexel Burnham Lambert opened the public credit market to speculative-grade corporations.

James Grant

"As leaverage amplifies financial success, so does it amplify failure."

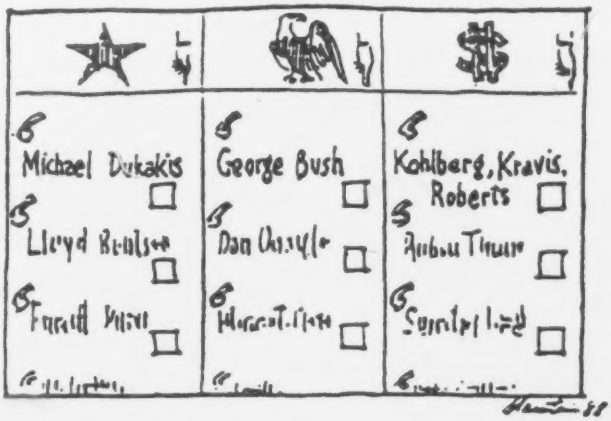
Some leading Wall Street economists have recently tried to set the bears straight. First, they say, the federal tax code has fostered the recent wave of borrowing—implying, it appears that rising corporate debt is inevitable and nobody's fault. Second, most of the corporate borrowing has occurred in recession-resistant industries. Third, the post-1983 bulge in corporate leverage is merely a reaction to unusually low rates of borrowing in the late 1970s. By extension, the bulls contend, the financial system is unburdened and the next recession will be no more severe than the last.

I thank the economists but worry about them. To start with, the tax-induced bias in favor of debt is as old as the income tax itself. The deductibility of corporate interest expense was written into the Tariff Act of 1913. It is odd, then, that the nation's financiers should only recently have discovered this loophole. In the late 1970s, when stock prices and real interest rates were low, Kohlberg, Kravis, Roberts & Co. (KKR) was doing $25-million deals. In 1989—a time of high stock prices and high real interest rates—it proposes a $25 billion deal.

Just as the bulls say, many of these leveraged transactions involve food and tobacco companies. But many do not. I believe in anecdotal evidence and in the axiom that signifi-

When to Say 'Enough!'

But there can be too much of anything, and there probably now is too much debt. I base this judgment, in part, on a close reading of junk-bond prospectuses. Typically, the fine print warns the reader not to expect his or her money back unless the borrower can sell some assets or refinance its debts at a future date. It says that the issuing company must produce significantly greater cash flow in the future than it has in the past, merely to stay out of the soup. The prospectus will imply, and sometimes state, that the issuer expects no business recession for the next five or ten years. Surely, before not too many years have passed, such passages will be read into the record of a congressional committee with utter incredulity all around.



cant trends are made at the margin. Thus, Wall Street has facilitated the leveraging of such highly cyclical businesses as gypsum, airlines, and department stores. At the margin, underwriting standards have been relaxed, interest-rate spreads have closed (as investors have crowded into high-yield securities), and competitors have crowded the lending field. Wall Street, ominously, has come to believe its own bullish research, making short-term "bridge" loans to leveraged client companies. Although the income tax hasn't changed, Wall Street has.

A law of paradox governs investments. It holds that good ideas are almost never popular and that the class of asset most favored by bankers is the least likely to succeed. It is worth noting, therefore, that banks are thronging the LBO market and that state pension plans have committed most of the funds to KKR's $5.6-billion leveraged buyout fund. Where were these capitalists a decade ago, when stocks and money were cheap?

Just as leverage amplifies financial success, so does it amplify failure. Climbing the stepladder of debt in this long business expansion, consumers have purchased more automobiles, dealmakers more companies, and politicians more voters. The most convincing reason to believe that the ladder will fall is that it always has before. The significance of a rising ratio of debt to GNP is that wealth is being pledged faster than it is being created. That cannot go on forever.

Living With Corporate Debt

Stephen S. Roach

By now, the legendary excesses of corporate debt have become deeply ingrained in the folklore of the U.S. economy. An unprecedented wave of mergers, acquisitions, and leveraged buy-outs (LBOs) is widely presumed to be an unmistakable sign that the explosion of debt has gone far enough. Indeed, fears are now rampant that just a modest uptick of interest rates is perfectly capable of unleashing an outbreak of business failures of the sort last seen in the darkness of the 1930s.

Fortunately, no such perils lurk in the seemingly treacherous waters of the financial marketplace. To be sure, there can be no mistaking the reality of an increased appetite for business leverage in recent years. Over 1982 to 1987, the growth pace of U.S. corporate debt (for companies other than financial institutions) rose to 12 percent per annum—a sharp acceleration from the 9 percent clip that had prevailed since the mid-1970s. Totally overlooked, however, is that the impact of this speed-up of debt creation appears to have been concentrated almost exclusively in those segments of the U.S. economy that are virtually recession-proof.

Indeed, recent trends in interest expenses—the ongoing obligations that are required to finance or "service" the outstanding volume of business indebtedness—reveal a sharp dichotomy in the so-called debt explosion of the 1980s. As shown in the first of the accompanying figures, there are three industry groupings where interest outlays have risen by about 10 percent per year over the past five years—public utilities, services, and nondurables manufacturing. While this portion of the economy collectively contributes only 30 percent to U.S. gross national product, it has accounted for 96 percent of the total growth in business debt service since 1982. For the remaining 70 percent of the U.S. economy, interest expenses have risen only about 1 percent per annum over the past five years.

Stephen S. Roach

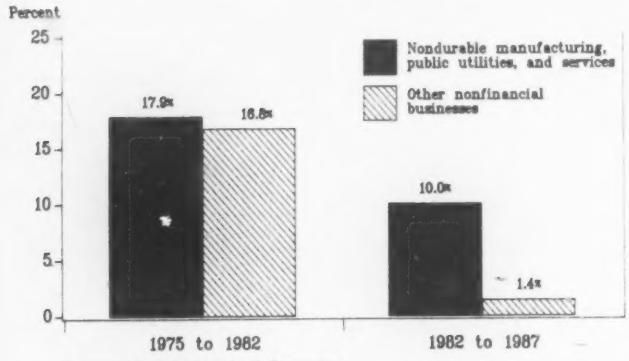
"The alarm rings hollow over rising debt."

The most intriguing aspect of this concentration in leverage is that it falls almost exclusively on those industries that have been the bedrock of stability over the course of the business cycle. Even in recessions, heating and electrical utility bills still have to be paid, the service sector continues its unrelenting expansion, and demand for consumer staples provides ongoing support for the earnings and cash flow of soft-goods producers. The recent growth in leverage is, thus, relatively benign—industries that bear the brunt of cyclical risk in the U.S. economy have been extremely cautious about increasing their exposure to rising interest expenses.

What About LBOs?

But what about the LBO frenzy? Concerns are increasingly prevalent that the explosive growth of these transactions—which spur debt creation in its purest form—reflects an increasingly reckless corporate mentality that has all but abandoned conventional risk considerations. While there can be

The Shifting Mix of Business Leverage
(Average Annual Changes in Net Interest Expenses)



Source: U.S. Department of Commerce.

no denying that the sheer size of recent deals greatly complicates the challenges of balance sheet management, the impact of the LBO can best be appreciated by seeing how it fits into the overall structure of business leverage in the United States.

The growing presence of the LBO is, of course, hard to quibble with. Indeed, the surging volume of such transactions appears to have accounted for about 14 percent of the total growth in U.S. corporate debt over the past decade. However, just as the accelerating growth of overall debt in recent years has been restricted to a relatively small segment of the economy, the same can be said for the impact of that portion of business leverage that can be attributed to the LBO.

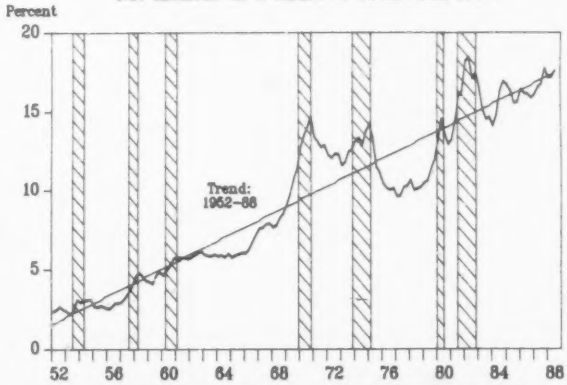
To be sure, the incidence of LBOs has been highly skewed toward manufacturing industries—with a Morgan Stanley tabulation suggesting that buy-outs in this sector amount to slightly more than 60 percent of all such deals completed over the 1978 to 1988 period. One way to evaluate the impact of this trend is to trace its repercussions through any subsequent shifts in the so-called debt-to-equity ratio—a widely followed indicator of balance in the corporate liability structure that gauges the "adequacy" of debt as it stacks up against the presumably more solid base of outstanding equity. On this basis, any excesses in the leveraging of Smokestack America appear to have been limited largely to the cash-flow-stable nondurables grouping. Indeed, over the past five years, the expansion in debt-to-equity ratios of soft-goods producers has outstripped the increase in durable goods industries by a factor of more than four to one.

Consequently, the LBO can hardly be accused of wreaking havoc on factory sector balance sheets. For durable goods producers—where cyclical risk is always a very real threat—measures of leverage are now only slightly above earlier highs. Consequently, for this segment of the economy the LBO has probably been used as a substitute for more traditional forms of debt. For nondurables industries, while LBOs seem to have played a role in boosting debt relative to equity, the cash-flow resilience of this sector offers a clear source of comfort. Key, however, is the fact that business borrowers have not allowed the LBO to stand in the way of recent efforts to shift the impact of debt service increasingly towards the growth-stable portions of the U.S. economy.

In a broader context, history points clearly to a longer term tendency of Corporate America to increase its reliance on debt. The rising debt intensity of the business sector, however, can hardly be judged as shocking for a country whose tax code has long permitted the deductibility of interest expenses but allows no such advantage for dividend payments. To the extent that businesses have used their liability base to finance the post-World-War-II growth of the U.S. economy, the biases of the tax code automatically produce an increasingly larger role for debt creation.

Thus, the alarm rings hollow over rising debt. To be sure, as many have pointed out, the widely followed barometer of corporate interest obligations to cash flow—shown in the second figure—has just hit a new record for an expansion period. But this is a gauge that has moved into uncharted territory during each and every upturn of the past four decades. What really matters is that the so-called liquidity squeeze of the 1980s is part and parcel of the same tax-induced trend that has driven the leveraging of U.S. businesses for nearly 40 years. Fortunately, since the incidence of recent debt growth has been unusually sensitive to the perils of business cycle risk, Corporate America can hardly be condemned as tottering on the brink of insolvency.

Corporate Liquidity Pressures:
Net Interest as a Share of Gross Cash Flow



Note: Gross cash flow is defined as pretax book profits plus book depreciation and net interest. Shaded areas indicate recessionary period as designated by the National Bureau of Economic Research.

The Equity Markets

George H. Heyman, Jr.

Nowhere is the "generation gap" more evident than in the stock market. From a market ruled essentially by the value-driven judgments of individual investors, the stock exchange has in the past decades witnessed a fundamental change in the emerging dominance of the institutional investor, whose embrace of modern computer-based trading strategies has produced investment decisions frequently uncoupled from equity valuations recognizable to observers more familiar with such conventional and time-honored investing standards as book value, equity returns, and cash flow. This seminal alteration of investing techniques has on occasion pushed equity prices to substantial premiums above values more easily demonstrable under accepted equity valuation models.

The stock market collapse of October 1987 was not unexpected in terms of such inexplicable premiums. Equity trading programs that influence institutions to acquire stocks regardless of price because the offsetting sales of futures will produce annualized yields in excess of Treasury bills must at some point produce substantial overvaluation in the underlying equities. Such was the case on October 19, 1987, and indeed several months before when the Dow Jones Industrial average crossed 2700. At these levels, the market was potentially selling at a 60 percent premium to certain equity value models. The correction to lower levels and the slow rise to the current level of 2160 suggest that we have seen some return to a more value-oriented equity market, although most pricing models still view current prices as reflecting a premium of as much as 25 percent over equity model derivations.

Additionally, the market has become a more volatile expression of investment judgments divorced in most instances from security values and more biased in the direction of instantenous responses to such exogenous macroeconomic news as trade figures, employment statistics, and changes in rates of inflation. Institutional portfolio adjustments to these phenomena cannot be viewed as rational reactions to short-term economic information likely to be of questionable influence over the long-term prospects for individual common stocks. Yet we will continue to be confronted with these sudden market changes, and they must be washed out of scenarios that attempt to analyze the more fundamental characteristics of equity prices.

If we search for the single most powerful determinant of equity prices, it is interest rates, because in the long run equity prices should reflect the discounted present value of the stream of future earnings and dividends. Obviously, assumptions as to earnings and dividends vary, although with respect to the more familiar, large capitalization companies, there is surprisingly small divergence in earnings and growth estimates. It is in the market's perception of future trends of interest rates that we see major differences, and these can reflect themselves in correspondingly wide variations in the resultant equity pricing. If we view the Standard and Poor 500 Index as a proxy for all equity prices, the effect of variations in interest rate assumptions at which such earnings and growth must be discounted is indeed dramatic. As an example, in the Goldman-Sachs valuation model, a 1 percentage point difference in the five-year government bond rate would affect the so-called justifiable share price of the S&P 500 by 11 percent.

George H. Heyman, Jr.
"Investment judgments divorced from security values."

Which Way in 1989?

This brings us to the question of what the stock market will do in 1989. Reverting to the Goldman Sachs model, at a 9 percent five-year interest rate and an earnings growth rate of 8 percent in the S&P 500, the so-called justifiable S&P 500 price ought to be 222, as against a current price of 278, or an overvaluation of about 25 percent. This derived valuation is somewhat understated. To begin with, to the extent that the model is based on a 5-year Treasury rate, the valuation suffers from the depressing effect of an inverted yield curve. In a more normal yield curve configuration with the 30-year Treasury bond at 9.10 percent, the 5-year bond yield might be closer to 8.40 percent, at which rate the derived S&P 500 price would be around 250, indicating a current overvaluation of 10 percent, hardly egregious.

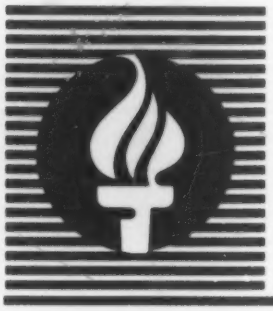
Second, since the S&P 500 represents large capitalization companies, it reflects the fact that as institutions are disinvested from their large capitalization holdings through buyouts, they are forced to reinvest in companies of similar size, which in a sense causes the S&P average to have a built-in premium over the market for smaller equities. Since 1984, the equity supply figure has shown an estimated cumulative deficit of slightly less than $300 billion. There has been no significant change over the period in institutional equity holdings as a percentage of total assets, and institutions have thus been forced into larger capitalization equities at prices probably in excess of those justifiable by equity models.

For the moment this trend will continue, unless interest rates

reach levels that make buy-outs uneconomic. Thus, a certain price premium above model values is warranted, barring an extraordinary rise in interest rates that current economic trends do not foretell. Absent a return to such interest rate levels, the stock market, as measured by the S&P 500, is likely to fluctuate around a central value of 275-290. This represents a 10-15 percent premium over a model value of 250, and recognizes the market's sanguine view of the trend of long-term interest rates, with which Shearson Lehman Hutton is presently inclined to agree.

It will be argued that a confluence of extrinsic factors such as LDC loans, the capital inadequacy of banks, burgeoning thirft losses and trade and budget deficits, will force a downward revaluation of equities. Barring a major credit collapse, it is clear that the market is implicitly recognizing these problems and has for better or worse already made investment judgments that take into consideration the implications of these macroeconomic pressures, at least to the extent that such factors are presently measurable. In addition, earnings estimates for 1989 may have to be tailored to reflect the possibility of a slowing in the economy, but if so the countervailing effect of reduced loan demand and lower interest rates is likely to give common stocks a "soft landing" not much more than 10 percent to 15 percent below market levels.

R4105-29.83F 4/89



The Conference Board

Managing Outside Memberships

Study data reveal how 196 major firms:

- *make membership and budget decisions*
- *manage company participation*
- *seek maximum rewards*

Research Bulletin No. 232

Method

This study is based on survey data provided by 196 U.S.-based companies, and on information gained through interviews conducted in the Spring of 1988 with executives having key organization-relations roles at 21 companies, and with the heads of several major trade associations. Questionnaires were mailed to 1,186 U.S.-based companies, consisting of assets of $500 million or more and other types of U.S.-based firms with sales of $100 million or more. Responding were: 62 manufacturing companies; 26 diversified companies engaging mainly in manufacture; 33 financial services firms; 27 utilities; and 48 companies in other businesses.

© 1989 The Conference Board, Inc.

THE CONFERENCE BOARD, INC.
845 Third Avenue, New York, N.Y. 10022
THE CONFERENCE BOARD OF CANADA
255 Smyth Road, Ottawa, Ontario, K1H-8M7, Canada
THE CONFERENCE BOARD, INC.
Avenue Louise, 207 Bte 5, B-1050 Brussels, Belgium
THE CONFERENCE BOARD, INC.
1755 Massachusetts Avenue, N.W., Suite 312, Washington, D.C. 20036

Managing Outside Memberships

by Seymour Lusterman

Highlights

This report focuses on how large U.S. companies manage their relations with outside business organizations. Virtually all such firms belong to national trade associations, to general business organizations, and to single-issue coalitions.[1] And all but a handful contribute to the support of public policy study groups. A voice in the shaping of public policy is often the sole basis for supporting these organizations and is almost always a major consideration. Each class of organization also offers a unique cluster of other opportunities to corporate supporters: as, e.g., executive networking, joint standards-setting, and product promotions. The management of membership programs involves two basic challenges. First, deciding which organizations to join—and, where the option exists, what level of support—and, second, ensuring that company personnel effectively participate in the outside groups.

Managing Membership Decisions: However decentralized, most of the companies surveyed seek some measure of central control over membership decisions. One out of five firms do so directly—by assigning company-wide budgeting responsibility to a single corporate executive or department. More often than not, all memberships within a particular class of organizations—i.e., trade associations, general business organizations, etc.—are on corporate budgets. Corporate budgeters sometimes charge-back costs to primary users or make proportionate cost allocations. In the great majority of companies, at least some memberships are also budgeted at divisional or operating levels. (A few firms, have placed all memberships at this level.) However, provision is often made for administrative review at the top to avoid membership duplication or to ensure conformity with corporate-wide legal or ethical standards. In some cases more substantive corporate-level intervention may also be required principally for approving costly or otherwise important memberships. Most often, CEO approval is required.

Managing Participation: Participation by company personnel is a condition and key criterion for memberships in nearly a third of the surveyed firms and is widely encouraged by the others. In about half the cases, the involvement of company personnel is monitored, coordinated, or otherwise managed by a designated corporate staff member or unit: four times out of five, this responsibility is carried by the firm's senior public affairs executive.

This activity includes three tasks: first, ensuring that all organizational bases are covered—that the firm is suitably represented on the boards and committees of appropriate organizations; second, guiding participation—ensuring that company personnel understand the firm's positions, interests and aims, and know what is expected of them; third, coordinating the efforts of company personnel within and among the various organizations.

Recent Change: Principally fueled by restructurings and pressures to contain or reduce costs, 72 percent of the surveyed companies thoroughly reappraised their membership budgets over the 1985-1988 period. They assessed both their affiliations and their levels of support. The result: Cuts in budgets for one or more types of membership organizations were reported by nearly half the firms—for all types of membership by 10 percent. Over 70 percent noted increases in at least one category, largely reflecting inflation-driven dues hikes, company growth due to mergers and acquisitions, and a greater need for organizational services. Among the firms surveyed, budgets for trade associations grew more often than for any other type of organization over 1985-1988—those for public policy study groups grew least.

More often than not, surveyed executives reported that the organizations they belong to today have become more valuable to them. The principal explanation is that their streamlined companies have a greater need for the services such groups provide.

Many outside organizations are feeling the effects not only of diminished support, but of other factors as well: Mergers and acquisitions have cost many of them net losses in membership; and there is an increasing number of organizations competing for corporate dollars. Some companies, in reallocating membership budgets, are concentrating their dollars in fewer organizations.

[1] Local, state and regional business organizations, as, e.g. local Chambers of Commerce and Private Industry Councils, are not analyzed in depth in this report: see Appendix.

Business Organizations and What They Offer

Top corporate executives and their staffs devote considerable time to working with other firms, many of them competitors, through organizations that serve shared business interests. Often millions of dollars, as well as countless hours of managerial and professional time, are invested in such activities. Managing membership programs entail two basic challenges—how to invest company dollars among the many organizations offering their services, and how to use company personnel effectively as participants in these groups. This study focuses on company memberships in organizations that reflect public policy interests—specifically, trade and industry associations, general business organizations, single-purpose organizations and coalitions, and public policy study groups.[1] Virtually all large companies belong to organizations in each of these categories. Public policy benefit—gaining legislative and regulatory intelligence, and advocacy—is visually their principal goal.

Trade Associations

Trade and industry associations, made up of companies engaging in similar kinds of business, stand out in a number of ways among the organizational types detailed in this report. (See Box) One is in the wide variety of benefits they are said by members to confer (See tables 1 and 2).

Second, trade associations are valued more widely than any other category for the two services most common to the various organization types. One is help in public affairs. ("We use them in lieu of our Washington office"; "They enable us to reach our public policy goals without always having to take the lead role"; "Associations are one tool, one source of information, one source of insight as to what may be coming and what may be changing.") The other involves the opportunities provided for executives to meet and exchange ideas with their peers. Like individual firms, trade associations must accommodate their public policy appetites to their financial means. They tend to avoid issues of minor concern to members, those on which members are divided, or for which other organizations—other trade groups, general business organizations, or coalitions—are carrying the fight.

Third, their key trade associations provide many companies with two benefits rarely gained from other groups: marketing support (cited by 65 percent of respondents) and the development of industry standards (75%) in areas as diverse as product and equipment design, industrial safety, and accounting practices.

Trade associations sometimes also provide compensation surveys, insurance, and purchasing services, claims processing, management development programs, and labor agreement monitoring. For example, the Grocery Manufacturers of America (GMA), which played a key role in the development and adoption of the Universal Product Code, also negotiates trade practices relating to the use and redemption of coupons. Trade associations are also often expected to provide members with information on matters ranging from charitable contributions practices in the industry to details of its legislative history.

While a few companies are affiliated with only one trade association, most consider at least two or three of major importance, and some are active in scores of them. Multiple memberships are based principally on product diversity, but also reflect differences among the associations in the character of their services and their constituencies. "If a larger, broad-based, industry group won't act on an issue, we can always bring it to one with a more specialized constituency," noted a study participant.

Thus, firms with closely-allied products as well as those with more varied lines, may belong to a number of associations. A steel manufacturer can work with any of forty-six industry associations, groups representing producers of raw

[1]The Conference Board, enjoined by its charter from public policy advocacy, belongs to none of these categories.

Trade Associations: How Many—and a Historical Footnote

One of the most ambitious studies of U.S. trade associations ever undertaken was that of the Temporary National Economic Committee (TNEC) published in 1941. It identified somewhat over 1,000 national trade associations and found that then, as now, government relations ranked first among the activities of trade associations.

No data comparable to those of the TNEC study are currently available. The 1989 edition of the Encyclopedia of Associations[1] lists 3,915 "trade, business and commercial organizations." Among them, however, are: professional societies (e.g., the American Accounting Association, made up of teachers and practitioners of accounting); professional certifying organizations (the Association for Certification of Computer Professionals); groups of retail dealers and other small business (The National Graphic Arts Dealers Association); and honorary societies. Together these far outnumber the trade associations of big business. Organizational categories are also blurring, as professional groups—the Society of Automotive Engineers, for example, which has recently started a government relations program, or the American Society for Training and Development—become increasingly involved in public policy debates, as advocates, as well as sources of expertise and information.

[1]Encyclopedia of Associations, 23rd Edition, Gale Research, Inc. 1989. Detroit, Michigan

Table 1: Benefits Derived by Companies From Key Organizations in Each Category

Through their reports, publications meetings, networking activities, communications programs, these organizations...	*Trade Assns.*	*General Business Orgs.*	*Single Purpose Orgs.*	*Public Policy Study Groups*
Provide opportunities for company executives to meet/exchange views and information with peers in other firms	92%	72%	47%	36%
Promote/lobby for company interests in national legislative and regulatory arenas	89	66	54	19
Help the company develop positions/priorities and action plans on policy issues	70	62	49	64
Provide guidance/input to corporate strategic planning	53	38	30	45
Contribute to the professional development/competence of company managers and other personnel	54	45	24	21
Promote use of industry products/favorable attitudes toward them	65	14	15	4
Development of standards for the industry	75	13	14	7
Provide guidance/input to decisions about the staffing, organization, budgets, management of key staff functions (public affairs, marketing, human resources, etc.)	28	27	24	10
Average number of benefits per company	6.3	4.2	3.2	2.4

Base: 193 companies

Table 2: The Principal Benefit(s) Derived by Companies From Key Organizations in Each Category

Through their reports, publications meetings, networking activities, communications programs, these organizations...	*General Trade Assns.*	*Single Business Orgs.*	*Purpose Orgs.*	*Public Policy Study Groups*
Promote/lobby for company interests in national legislative and regulatory arenas	61%	45%	58%	7%
Help the company develop positions/priorities and action plans on policy issues	23	27	37	65
Provide opportunities for company executives to meet/exchange views and information with peers in other firms	42	40	10	12
Provide guidance/input to corporate strategic planning	5	5	7	26
Contribute to the professional development/competence of company managers and other personnel	2	5	6	8
Promote use of industry products/favorable attitudes toward them	8	2	–	–
Development standards for the industry	13	1	–	–
Provide guidance/input to decisions about the staffing, organization, budgets, management of key staff functions (public affairs, marketing, human resources, etc.)	–	3	6	1

Base: 193 companies

iron and steel, fabricators of steel products, construction firms, and intermediate steel purchasers. One electronics manufacturer reports that it belongs specifically to: American Electronics Association; Computer and Business Equipment Manufacturers Association; Electronics Industries Association; National Electrical Manufacturers Association; Scientific Apparatus Makers Association; and Semiconductor Industries Association.

Companies also belong to trade associations because their members are among the company's customers. An equip-

Benefits Cited for Membership in the American Electronics Association

Public Affairs

Influence with decision makers.

AEA is the major vehicle through which electronics companies can work successfully toward an industry-supportive environment on federal, state and international levels. Grassroots political support programs allow executives to educate local legislators.

Issue areas: tax policy/capital formation; education, science and technology policy; federal procurement; international trade policy/export regulation; international market support; human resources; environmental and occupational health.

Committees: You can contribute to the industry through service on AEA policy committees and single-purpose task forces. They include: Domestic Public Affairs; International Public Affairs; National State Government Affairs; Engineering Education; Environmental & Occupational Health; Governmental Acquisitions; Tax; Trade and Investment; Education Legislative; Customs; Export Control; Government Relations; Lawyers; Human Resources.

Networking

The largest business/customer network of technology companies in the U.S.

Twenty AEA councils provide opportunities for executives from member companies to make contacts and discuss common management issues through council committees and local meetings, including dinner meetings, and forums for CEO's, CFOs, and marketing, small business, and human resources executives.

Compensation Surveys

Information to help your company make informed compensation decisions.

AEA surveys reveal how competitive your compensation programs are within the industry. Surveys cover executives, engineers, sales people, supervisory and nonsupervisory benchmark positions, and foreign national and expatriate employees. An employee benefits survey covers the full range of benefits for exempt and nonexempt employees.

Financial Conferences

Productive meetings with the investment community.

Public companies can cultivate relationships and maintain communication with analysts and portfolio managers, and private companies can talk with potential investors and AEA financial conferences. Several of each type of conference are held each year on both East and West coasts. Conferences for public companies also are held in Europe and Japan.

Management Education

Annual institutes to expand knowledge and strengthen management skills.

AEA institutes and seminars afford senior and mid-level managers unmatched opportunities to learn and trade business experiences with industry peers.

Services

Cost savings on basic business services and employee benefits.

AEA's large and effective group purchasing power results in lower rates for insurance programs; 401(k) plans; and car rental, van line, corporate travel and overnight courier services. Dividends and membership dues credits are offered.

Publications

Helpful information for management.

Newsletters, directories, guidebooks and videotapes give member company management in nearly all functional areas useful information that can broaden perspective and increase productivity. In addition, members have their companies and products listed in the widely used AEA Directory, the "bible of the electronics industry."

Source: An AEA publications. 1988.

ment manufacturer, for example, divides its association membership into two classes. "First," a company official says, "are our industry associations, 15 or 20 of them, of which 12 are fundamentaly important. Second, are groups we join to be in communication with, and understand the problems of, both the retailers who sell our products and major groups of our customers. The unit responsible for marketing point-of-sale products to supermarkets, for example, belongs to the grocers' association."

Some surveyed executives see a need for—and recent progress toward—greater cooperation among their key trade associations so that: (a) each group concentrates on issues it is best qualified to deal with; (b) identical or compatable positions are taken whenever possible; (c) with the backing of the others, the best qualified group takes the lobbying lead on legislative issues.

General Business Organizations

Organizations such as The U.S. Chamber of Commerce, The National Association of Manufacturers (NAM), and the Business Roundtable, that draw members from a variety of industry groups and address a broad range of public policy issues, constitute the class of general business organizations. Other examples are the Association of National Advertisers and the National Foreign Trade Council.

Like trade associations, though to a lesser degree, these organizations are widely valued for their role in public affairs. Lobbying activities, in particular, are among their principal value to members. They are also important vehicles for executive networking.

The value of any business organization to its members lies less, perhaps, in the scope and depth of its public affairs capa-

bilities than in how often it takes on issues that are seen to be vital or important. Despite their relatively high degree of member homogeneity even trade associations are often divided by differences on policy issues—disagreements that can either paralyze the organization or lead to dissatisfaction and alienation among member segments.

Larger and more broadly-based than individual trade associations, general business organizations achieve member accord on fewer issues. Members tend to judge their worth on the importance to the company of the particular consensus issues on which they act over a period of time. Thus, one or more of these organizations were praised by respondents for their efforts in connection with trade policy, plant closure, corporate governance, aspects of labor relations, environmental, and tax and policy. A telecommunications company executive feels able to say that "among the various kinds of outside organizations the general business groups provide us the greatest benefit."

A common opinion about these groups is voiced by a mining company executive: "The general business organizations free us to concentrate on the more compelling issues—which is not to say that the ones they tackle don't have bottom-line effect." Another executive comments: "They do some good work, but don't help us much on our major issues." The most skeptical view is that general business organizations are "too often rendered impotent by having to take positions based on the lowest common denominator of member interest." But at a minimum they are valued by members for what one describes as "their promotion of the idea that business health should be an important goal of public policy."

Many surveyed executives were quick to point to differences in the character and effectiveness of particular organizations. Washington-based staff capabilities and programs are not their sole criterion. Thus, one participant, who also sees in the U.S. Chamber a recently increased emphasis on small-business interests, gives it high ratings for its ability "to rally a huge grassroots network for certain occasion." Several differentiate among these groups in ideological terms. The Washington-office head of a leading manufacturer asserts that the NAM "has become one of the most enlightened organizations in town." His company belongs to the US Chamber "simply because that organization needs some voices of reason and moderation." Another says:" The U.S. Chamber very rarely takes on an issue we care that much about and we often disagree with its positions. But it acts from a point of view about business and government that we think deserves support."

Single-purpose Organizations

Single-issue organizations and coalitions bring together different kinds of businesses in pursuit of common public policy interests. Their strength rests on the size, character, and breadth of the constituencies they represent—and is enhanced, some suggest, by their freedom from the special-interest image that taints some established lobbying groups. Participants may consist entirely of individual firms, but often include trade associations as well, and sometimes general business organizations and non-business groups. During recent years single-purpose groups have multiplied both in number and prominence, "part of a change," one executive observed, "that has taken place in American politics as a whole."

Some single issue bodies exist only for the life of particular legislative battles. Others, like the Washington Business Group on Health and the Emergency Committee for American Trade, direct their attention to multifaceted and inherently long-term issues: They tend to become special purpose organizations, having their own staffs, offices, bi-laws and membership fee structures.

Shorter-term coalitions may have more than one life. A telecommunications executive noted:

> "In 1986," noted a telecommunications executive, "we joined with AT&T, some large equipment manufacturers like Northern Telecom, and certain customer organizations, in forming a coalition. We succeeded in killing a bill that essentially would have permitted the Bell companies to get back into businesses that were closed to them under the break-up decision that spun them off AT&T. The coalition stayed in business about nine months. If this issue surfaces again in some other form, we will coalesce anew. The players all know each other now, and our positions are pretty well sorted out."

Some coalitions are formed on the initiative of general business organizations or trade associations, seeking to muster allies. Individual firms may also spark the creation of such groups. They may do so, first, when their business organizations cannot reach acceptable positions on important issues. "Members of the American Paper Institute having operations in Canada were at odds with the rest of us on the question of softwood imports from that country," an International Paper Company executive said: "API could not take a position, so we put together a coalition—a highly successful one."

Companies may take the coalition road even when there is agreement on policy within their trade and business groups, if the commitment of these organizations to an issue is not deemed strong enough. "Four or five years ago we joined with IBM to form the Intellectual Property Rights Committee and then invited eight or ten other firms to become involved," said Pfizer's vice president for public affairs "It wasn't because the major associations had no interest in the issue, but rather that ours was far greater."

Though their differences are apt to be relatively narrow, coalition participants are also not free from disagreement about aims or methods. One Washington-office head commented: "A learning and trade-off process is inherent in them. We took part with other high-tech firms in a coalition around the issue of R&D and the tax law. There was consensus about the basic issue, but the hardware and software firms differed on the specific kind of R&D tax credit that would be acceptable."

Public Policy Study Groups

Groups like the American Enterprise Institute, the Brookings Institution, the Committee for Economic Development and the Heritage Foundation contribute to the aims of supporting firms is several ways.

First, their studies, reports and in-house expertise help such companies in their plans and programs development. Most of this refers to public affairs—to their ability to understand the ramifications of issues and develop positions, set priorities, and devise action plans. Corporate supporters also believe that the work of these groups tends to authenticate and promote the public policies they espouse. Contributions, thus, go to think tanks having social, political and economic perspectives shared and approved by the company's management. "Even though these groups don't advocate, as such, they provide foundation stones and spur movement," one participant says.

The desired policy directions do not necessarily concern issues of key importance to the firm. As one executive explains: "We're looking for studies and reports that contribute to effective policy-making on the broader issues—the federal deficit, for example—issues on which we're not going to put much lobbying time."

Contributors may at times seek to influence the programs and the conclusions of supported organizations. One executive says: "Although you have to drop a pile to do this, we have tied grants to an organization's willingness to devote more attention to certain issues." Another comments: "Our contributions give us the opportunity to deal directly with their people and to help steer them to a correct and balanced view of our industry and its problems."

One out of four (26 percent) of the companies say the main value of these groups is in their contribution to corporate strategic planning rather than simply to public affairs. This help comes not only from published materials, seminars, and meetings, but also from direct consultation with staff specialists. Speaking of a west coast think tank, the public affairs chief of a firm based in that region said: "There are people in the organization we stay in touch with. We feed off their ideas. We use them to test our thinking." A multinational company executive commented: "Support to Brookings entitled us to so many hours of research, and we had them do some work for our financial planning group on the dollar-yen relationship."

The goal of providing their planners with a variety of viewpoints guides the support programs of some companies. "We're a highly diverse and global company," one executive said. "On issues like the health care system and its costs, the formulations we get from these groups—conflicting to some degree, but each very thoughtful—are grist for the broad internal assessments from which our positions and policies emerge." Internal practices, as well as public policy, may be at stake. One participant reported that his company's decision to institute pre-employment drug testing "was significantly influenced by some of the studies of these organizations."

The work of study groups also helps some companies clarify their goals and priorities. One executive says: "You're always poised somewhere between being too passive and spreading yourself too thin. The material from AEI, Brookings, and the others helps us gain perspective. Sometimes that means getting into an issue we otherwise wouldn't have considered important enough." Finally, participants note that the research output of these groups—and Brookings monthly seminars on the federal system more directly—contributes to the development of public affairs competence in executives who are not specialists in this field.

Several senior public affairs executives interviewed for this study professed to see very marginal benefits, if any, from their companies' support of these organizations. "I see some conservative background music coming out of our contribution," one commented. "We provide a place for bright people to consider and talk about the broad issues," another said. Non-contributors see insufficient benefits. "We have to focus our limited resources on groups that can help us more directly," a mining company executive stated. "We don't believe that giving money to such organizations is our job," explained another participant.

Membership Considerations

Memberships are predicated on rewards. "I see these organizations as parts of our public affairs issues management system," a company officer noted. "They gain or lose importance as issues come and go, or wax and wane, but also as other parts of the system change—our professional staff resources, the involvement of senior management and of others in our company and our use of private outside resources."

Some cost-benefit judgments are readily made. It is not surprising, for example, that an automobile manufacturer, sharing with competitors such concerns as fuel-economy and emission-control standards, passenger safety, and import-export rules, considers membership in the Motor Vehicle Manufacturers Association "almost obligatory." Comparable issues bind other kinds of companies to their key trade groups.

But not many memberships are essential, while the field of possibilities is great. "An organization may become a candidate for company membership in any one of three ways," a participant observes: "It may solicit our membership; our chairman may say 'why aren't we in it'; or someone else in the company may become aware of the organization's work and consider it important to his or her responsibilities."Deciding which organizations will best address policy issues of importance to the company and gauging how benefits will compare with costs is often difficult. Companies consider how congruent member interests are, how

differences will be played out, and how politically effective the organization will prove to be in pursuing its policy goals. (Realistically, as participants observed, judgments about an organization's worth also come up against the constraints of tradition. "If an organization has been supported—and has been supportive—in the past, and management is used to the idea of belonging, I tend to recommend renewal even if I feel that the relationship is not very productive," one public affairs vice president commented.)

One consideration in judging an organization's worth is its potential political clout. No less critical, however, given the diverse and often divergent interests within most groups, is the likelihood that the company will agree with or be able to influence the organization's positions and priorities. "How important are the stakes? What are the chances that we can make a real difference? These are the key questions," one participant says."

Even firms similar enough to share membership in particular trade associations may be splintered by differences in size, location, geographic scope of operations, methods of production, or markets. One result is that trade associations become arenas in which participants practice the political arts of cultivating allies, negotiating compromises, and wielding power judiciously.

Questions often arise in membership groups about the adequacy of the top leaders and staff, their committee structures, criteria for membership, fee schedules, and the like. Some surveyed executives charge the heads of particular organizations with empire-building, the creation of cliques, and over-assertiveness in pressing their views—and other staff personnel are criticized for paying too little attention to enlisting member participation. Members sometimes also disagree about the allocation of resources among program areas, such as marketing, standard setting, public information, government affairs, or others.

Participation by its personnel may be necessary for a company to influence an organization's programs and policies, but is not a guarantee that the firm's interests will prevail. Larger members usually have more clout than smaller ones and, in some organizations, the power of top dues-payers is institutionalized through disproportionate representation on boards and executive committees.

Another special power of large members is the implicit threat of withdrawal. "Sure, we pay over a million dollars in dues," an International Paper Company executive says: "Without us the American Paper Institute would be quite a bit weaker—so would the Chemical Manufacturers Association without DuPont or Dow, or the American Iron and Steel Institute without U.S. Steel." The public affairs chief of a smaller firm illustrates this power: "If executive committee discussions showed that 15 of the 18 members favored a policy, but that the three opposing it were top supporters of the association, the issue would never come to a vote and no position would be taken."

But larger firms do not always have their way. Their power is often diluted when membership is large. Rather than risk losing the strength of numbers and industry unity on certain issues—or, in some cases, the favor of members with whom they also have business relations—top firms may not press positions that others oppose and sometimes even go with stands they do not altogether approve. "There's constant friction," a large-company executive observed: "But we need the political weight of the smaller members, so patience and flexibility is called for. And we're educating them about political action, because a lot of the friction is based on a lack of political understanding, or orientation, rather than on conflict of interest."

Where smaller firms dominate, as another executive testified, the frustration may be acute. "The larger companies like ours provide staff for most of the committees, but the smaller ones control the board and really set policy. Increasingly our people have felt that the board is ignoring the priorities that come out of the committees and undermining their ability to work on behalf of the industry as a whole. Instead, it focuses on some relatively narrow interest of one of the board's CEOs, many of whom are not aware of the significance of issues they're declining to work on."

The largest members of an association are not always in agreement, of course, and top dues-payers may lose out on policy decisions to companies of comparable size.

Managing Budgets and Membership Decisions

Most firms maintain important company-wide controls within headquarters structures, but allow divisions and operating units to participate in membership decisions that affect them and to budget and manage some affiliations on their own. A corporate-level executive is almost always responsible for certain membership budgets and for various coordinating and oversight roles as well. Given the public policy interests that underlie most of the affiliations under study here, this role is assigned, more often than not, to the firm's senior external or public affairs executive.

Companies organize to manage their membership decision in three ways:

- At the great majority, some organizations are on corporate budgets, and some on those of operating units (See Box on p. 10). This group includes a number of firms that bring all organizations with significant public affairs pro-

grams under the corporate umbrella. Divisional units in these companies, as one public affairs director says, "are free to join organizations offering other primary benefits, but any group that gets into regulatory matters or legislative advocacy belongs to us." In terms of public policy management, then, organization relations are as completely centralized among these firms as they are among companies in the first group.

- One in every five firms reports complete centralization: Every type of membership under study is on a corporate department budget. All industry types are well represented among these firms, and the group includes several manufacturing giants; but financial service companies, utilities, and smaller companies are encountered somewhat disproportionately.
- A handful of companies say exactly the opposite—that budgets for all memberships are maintained at operating units.

A company's practice, the study suggests, depends as often on its traditions, organizational history and style of management as on more readily observable characteristics, such as size, industry class, and product diversity.

Partial Centralization

Corporate-level responsibility for all organizations within a particular class is quite common. Thus, public policy study groups are found exclusively in corporate budgets in four out of five companies, single-issue groups in nearly half of them, and trade associations in better than a third. (See Table 3.)

Budgetary responsibility is normally assigned to corporate headquarters executives for organizations that serve company-wide interests—or that have no particular constituency at operating-unit levels. "We carry the NAM and the Chamber on our budget," a Washington-office head says, "because we're the only ones that work closely with these groups. Other company participants, including the CEO, give most of their time to our key trade associations."

Corporate budgeting sometimes serves as an administrative convenience. When two or more operating units have reason to belong to the same organization, for example, the membership may be carried either on the corporate budget or that of one of the interested units. Company-wide scans are sometimes made to ascertain whether other departments or units are interested in sharing a new or ongoing membership.

Multi-departmental Budgeting

Multi-unit budgeting of organization memberships, by far the most common corporate practice, is illustrated by arrangements at Chrysler Corporation. Each of its major operating units—Chrysler Motors, Chrysler Capital, etc.—initiates and budgets its own memberships, subject to corporate audit and review. Michigan and Detroit groups are a responsibility of the Vice President for Corporate Planning and External Affairs. This executive also carries the National Association of Manufacturers and other general business organizations on his departmental budget. Single-issue organizations and temporary coalitions in Washington, as well as public policy study groups like Brookings and the American Enterprise Institute, are on the budget of the Public Affairs Department's unit in the capitol.

Occasionally too, a trade associations in a multi-divisional company is maintained on a corporate budget even though the organization serves a single division. This arrangement may reflect the size or special importance of the division to company earnings and growth. For example, a CIGNA Company executive reports "Budgets for trade associations that are significant, totaling over four million dollars, are approved jointly by the head of public affairs and the related line of business. The expense is carried on the public affairs budget but charged back to the business. General business organization budgets are carried on the public affairs budget." Corporate budgeting may also spring from a desire to maintain the continuity of personnel and programs when mergers or acquisitions have occurred.

Public affairs heads who do not command trade association budgets report occasional frustration over the unwillingness of operating units to undertake what they consider to be desirable affiliations. A manufacturing firm's vice president for external affairs says: "One of the electrical manufacturing associations—an active group that could be quite useful to the company—has been badgering us to join, but I can't get anyone in our operating group to make a committment."

Table 3: Where Memberships are Budgeted

	Type of Organization			
Budgeting is at:	*Trade Assns.*	*General Business Orgs.*	*Single Purpose Orgs.*	*Public Policy Study Groups*
Corporate level only	38%	68%	47%	81%
Divisional/operating levels only	9	5	10	3
Both levels	53	27	43	16
TOTALS	100%	100%	100%	100%

Complete Centralization

Corporate budgeting ensures central coordination and control of membership programs. It makes manifest to top-company planners the size and nature of the firm's investment in outside groups, and facilitates the appraisal of individual organizations and of membership lists. Computer analysis with organizations classed by type and keyed for other variables, aids the process in more and more companies. Where central budgeting exists, however, operating managers play an active, and often powerful, part in decisions to participate in or join a particular organization. The government affairs director of a heavy equipment manufacturer says, for example: "The budget is in one location for coordination purposes, but recommendations by operational personnel throughout the company are the key decision factors." Comments from several of the corporate executives with budget responsibilities illuminate these relationships.

- "Our entire planning and budget process is constructed and driven to serve the needs of line management. I'm not going to sit here and second-guess the president of a major division who makes a case for belonging to a trade group." (A conglomerate.)
- "Our management is usually pretty light. If divisional executives want to become members of an organization we're likely to be willing to join. But we'll test their thinking a bit. If we pose good, tough, questions that indicate real skepticism, they'll think hard about it." (A high-tech manufacturing company.)
- "The memberships that really take vigilance are the ones that have been going on for so long that they become ingrained and institutionalized. We really have to force people to take a hard look." (A petroleum company.)

Corporate budgeting often entails charge-backs to operating units. Usually this is done only in connection with those organizations that are uniquely valuable to particular divisions and joined at their behest. All memberships at a steel company, for example, are on a corporate contributions and membership budget, but any that can be identified with a particular corporate entity are charged to it, a company executive reports. In some firms, however, all organizational costs are allocated internally. (At least one of them, a leading natural resources firm, is reconsidering this practice. "How can you claim to be measuring an operating unit's performance," an executive at this firm asks, "when so many of the charges against its budget are based on decisions made, with the stroke of a pen, at the corporate level.")

The Responsible Corporate Unit

Corporate control of memberships, like the affiliations themselves, is motivated principally by public affairs considerations. Insofar as organization budgeting is a corporate level function, it is more often than not a responsibility of the public affairs or government relations department or of a corporate contributions unit within it.

Otherwise, budgets are reported, variously, to be in administration, community relations, or human resources units, or placed with the corporate secretary or treasurer. Groups in which the chief executive is active or holds a key job are sometimes on the top executive's budget: Often mentioned are the Business Roundtable and the NAM, though at least one chairman's budget includes the firm's key trade association.

Occasionally budgets for different organizations within a class—most often, single purpose groups—are divided among several corporate departments. The head of government relations at a leading manufacturing firm says: "Our idea is that we're a service organization. If we thought it was worth supporting and getting involved with a new coalition we'd try to get the lawyers, or the tax or finance people, or whoever was most concerned with the issue, to share the cost—because we'd really be reporting back to them." Corporate public affairs units may be responsible for all memberships even where the function is decentralized in other respects. Hewlett-Packard's director of government relations says:

> "Our Medical Products Group, has a person who works full-time on device regulation—a person with whom we have virtually no involvement. It also has a staff member who is active in the health care management and policy area, working very closely with the corporate personnel department, which also has an interest in the subject. This person has a very strong dotted-line into our Washington office and is housed there during the three-quarters of his time spent in the Capitol. But we maintain the company membership in the Medical Group's two key associations, the theory being that they're representing us on the Hill and we want to have some idea of what's being said in our name overall. We also want to avoid conflicting representation."

Divisional Decision and Corporate Review

In keeping with principles of divisional autonomy, little or no top-company effort is made at many firms to influence or control the membership decisions of operating managers (See Box). Trade association budgets, for example, are approved by senior executives at operating or divisional levels in a quarter of the surveyed firms—as are budgets for single-purpose organizations.

Some managements see no need for higher-level review. "We figure cost is a sufficiently effective policing instrument," one senior executive comments. Others have not devised the means. A utilities executive observes that "the scattering of budgeting and membership review procedures among various staff and operating entities within the company maximizes the match between company units and their organizations but makes centralized review difficult."

Often, however, corporate management places limits on divisional budgeting autonomy. Provision may simply be made for certain kinds of administrative review. For example: Procedures are mandated in some companies to ensure

conformity with legal or ethical standards. One high-tech manufacturer requires that both its legal and industry relations departments examine all proposals to join new organizations to ensure, as a company executive puts it, "that nothing in their by laws or organization statements are discriminatory or exclusionary, or could in any other way prove embarrassing."

Corporate units may also serve clearing-house purposes. One public affairs executive says: "Our review function is needed to avoid duplicate representation and to make sure we don't find ourselves with one person turning down a membership and another, unaware of this, saying 'yes'."

In many firms, corporate review of divisional memberships and budgets is required for the more important or high-cost organizations. "We monitor annually our participation in and benefits from every external organization to which we pay annual dues of $1,000 or above," says Air Products and Chemicals' vice president for public affairs. "The decision to join any organization above $1,000 rests with the functional line or staff officer concerned. We have a standard review from which must be filled out before any annual dues are requested, approved, and mailed. I review every form. The forms indicate our level of participation and the value received for the investment made. On this basis, we cancel approximately three or four memberships a year out of a total of about 100 to 110."

More than one level of corporate approval may be mandated. At Eaton Corporation, for example, a corporate contributions committee chaired by the vice president for corporate affairs "will review requests and approve or disapprove payments up to and including $25,000 to any one organization in any one year," an internal policy and procedure bulletin states: "Payments beyond this amount also require the approval of the Chariman and Chief Executive Officer."

AT&T's external affairs director reports, similarly: "The various trade associations, general business organizations, and other groups require different levels of approval, based on their price tag, but often, too, on the magnitude of the commitment in terms of other resources. Clearly, immediacy and urgency enter into the decision process as well." Other firms also report "clip-points," dollar cost levels, at which managers must go to higher levels for approval of new memberships—and, sometimes, for renewals as well.

Top company review and approval, finally, is often required for all memberships. "Although formal budgets are not prepared at the corporate level, expenditure control is exercised in reviewing requests for renewal," a public affairs executive reports. The corporate public affairs or corporate contributions head usually has responsibility for consolidating individual unit budgets to facilitate this process. Allied Signal's senior vice president for public affairs reports that budget information is collected by his department from all operating units, "assembled into a single budget, reviewed for level of expenditures and value to the company, and then submitted to the CEO for approval."

Aggregated budgets are normally reviewed at top corporate levels after components have been approved by division and department heads and after particular high-cost organizations have also been OK'd at prescribed levels. The primary concern is often with overall budget size, but questions may be raised about high-cost affiliations. "While board members see lists of specific organizations," a financial service company executive says, "they typically only vote to approve the total dues budget. It is their prerogative, however, to challenge any item contained therein."

Where budgets are subject to top-company approval, the CEO is the effective authority more often than any other individual or body, though in not quite half of the surveyed firms. Corporate-level approval of trade association budgets, for example, is by CEOs in 46 percent of the companies, by executive or management committees in 38 percent, by boards of directors or board committees in 9 percent, and by another senior corporate executive in the remaining 8 percent. Ratios for other types of organizations are virtually identical to these.

Budget Proposals

The development of budget recommendations is typically an informal process. Suggestions and opinions are gathered from department heads and key participants in the various organizations by memo, telephone, and face-to-face. One company convenes meetings at which all personnel participating on the committees of key organizations are questioned by top executives about the past and potential benefits of membership. Public affairs budgeters—in some cases, others as well—also bring judgments gained from their direct involvement in organizational activities and from daily interaction with participants from other parts of the company. Proposed membership lists and budgets are often circulated among a number of key executives for comment: the head of contributions for a textile company says these go to "every imaginable person before they get to the top."

Some companies invite the organizations themselves to contribute to the budgeting process by reporting on the services they have rendered. "They understand that it's in their interest to help us provide the kinds of benefits statements and justifications for membership that top management requires," one executive says: "And we get some interesting insights as to values they've brought to us."

A small but growing number of companies develop budget recommendations, and justify them to higher management, with the support of written, organization-by-organization documentation. Some have done so episodically, in response to budget cut-backs, increased efficiency, or tighter control. Elsewhere, written evaluations have become part of the annual budget process as they have at United Technologies over the past two years. A public affairs manager there says, "our computer now kicks out a spread sheet for each executive who is responsible for one or more organizations. It lists his

or her groups, and asks for evaluations. 'Are the dollars bringing a good business return? Is the organization still meeting your objectives—your expectation of it? Does it fit your operation's strategic plan? Has it done what is promised to do? Should we discontinue our membership, sustain it at the present rate, or agree to a requested increase'."

Annual "account plans" accompany budget recommendations at AT&T. Prepared by members of the external affairs department each of whose responsibility it is to manage relations with from two to twelve organizations, they are statements of "what we expect to achieve through each of our memberships, what we're going to do to reach our goals, and how well last year's objectives were met," a company executive says. Included in these account plans—for new, as well as continuing memberships—are the names of AT&T personnel who are to serve on the various committees of each group.

Surveyed executives stress the judgmental character of budgeting and membership decisions. But such judgments as many recognize, are based on quantitative considerations. When a firm decides to reduce its membership budget for example, the organizations droped are those judged to offer the least favorable ratio of benefits to costs. Some companies try to make the process of quantification more explicit and structured. One way is by asking key departments and operating units to rank in order of their value the organizations in which they participate or have expressed interest. Another way is to have users rate performance and usefulness of various groups in terms of specific criteria and overall company benefit.

Managing Company Participation

Participation by company personnel is said to be the key to achieving maximum benefits from outside memberships. Their activities are usually guided by company policies and often are centrally managed to ensure: (a) that all important organizational bases are covered, i.e., that the firm is suitably represented on the boards and committees of appropriate organizations; (b) that participants understand company positions, interests and aims and know what is expected of them; and (c) that the policy goals of company personnel within these various organizations are coordinated.

Company Policies

Whether formally set down, or simply understood by the firm's managers, most company policies are geared to the perception that influence requires involvement. Selecting from five possible characterizations of their company's policy offered by the Board's survey, 68 percent of the survey respondents reported that participation in the work of business organizations is required or encouraged by top management. "There are exceptions," a USX executive says, "but generally, if we put our money in a group we want to know what's going on and to be a part of it."

Some firms have introduced this as a formal requirement. A manufacturer, for example, stipulates two conditions for outside memberships. An executive of that company says: "First, there must be a manager who champions the organization; second, the manager must be committed to active involvement." Hewlett-Packard insists on a "real champion," as well as on opportunities for company participants to have a voice in a group's policies. Its director of government affairs noted, "a request by a manager who is willing to invest people—who will be on a board and commit three people to active work on other committees—is likely to pass the test." An equipment manufacturer's public affairs head thinks his company is missing a bet by not joining an association that is effective in areas bearing on company interests. "But I can't get interested enough to commit and there's no sense belonging if you don't have a key member," he says. Participation is said to be encouraged—though not a condition of membership—in another 37 percent of the surveyed firms. Together with the first group, then, 68 percent of the survey respondents understand that participation in the work of business organizations is required or encouraged by top management. In most of the remaining firms (32%), participation is said to be left to the discretion of interested personnel and their supervisors. In a number of companies, participation is deemed proper only where it can be shown to entail direct value and benefit to the company.

In none of the surveyed firms was participation said to be discouraged. But some companies, particularly smaller ones, are relatively passive members of their business organizations. This may be because of tight staffing or from what one study participant called "an insular company culture." "We have never tried to be a leader in trade association activities," he said.

Company policies and levels of participation generally vary according to the company's stake in public policy issues, the effectiveness of available organizations and the availability of its personnel. One executive says: "We tend

Opportunities for Participation

Since a major part of the work of business organizations is carried out by personnel of member companies, there is no lack of opportunity for participation. Committee roles are typically available for the asking, and associations have an ongoing need for specialized help as they take on new issues. It is not unusual for a major company to have scores of its people on outside boards, committees, and task forces.

The importance attached to these organizations by top executives is widely attested to by their own participation on governing and policy-making bodies. Organizations with limited memberships may invite the CEOs or other top executives of all the members to sit on their boards. Some associations allocate more than one board slot to their larger members. Otherwise, board membership is usually by election, though that procedure is sometimes little more than a way of validating volunteered offices. Rotation of board members is a common practice and, over a period of years, widens member participation at the policy-making level of the association. Board rotation sometimes involves top executives of individual firms: The chairman, president, and vice president for finance of a pharmaceutical company, for example, have taken turns as the firm's representatives on the board of the National Association of Manufacturers.

Public policy committees play a key role in general business organizations and larger trade associations. These committees develop and recommend positions on policy issues—usually for board or executive committee consideration—and plan, coordinate, and participate in lobbying efforts.

Company representatives on these committees are usually top government affairs executives or those having such responsibilities for particular product groups. In some cases, they are CEOs.

Participating in other specialized committees, subcommittees, and task forces are company managers with expertise in human resources, finance, law, engineering, environmental science, and other areas. A major part of their function is to provide the technical underpinning needed to evaluate issues selected by their company's policy makers and by the public policy com- mittees and boards of the associations.

During the course of long-term working relationships with members, trade association personnel come to know who they can turn to in a member company for particular kinds of expertise. A Chevron executive noted: "Our Health, Safety and Loss Prevention group deals with everything from traffic accidents to OSHA compliance. Someone in that organization will be the company's expert on tank design standards. At some point the American Petroleum Institute is going to call on this person and he or she will be drawn into the association's activities."

to operate more aggressively than some companies because we need these organizations badly, relying heavily on them. Other firms, with fewer or narrower interests, work as occasion demands—and expect their associations to deliver." Most of those interviewed for this study believe that temperament and inclination play a significant part as well. One executive commented: "We public affairs directors are a diverse group, and the same goes for our CEOs. Some of us are political, at home in the political fray; others are insular, oriented internally, uneasy about the idea of doing things like lobbying."

Participation in certain groups may be slight even by basically aggressive firms. But there is an essential minimum, one executive suggests: "When we know we're a peripheral player, that we're not going to get on the board or the trustees list, we still designate someone as the contact—not just to get the mail, but to make an informed judgment at the end of the year as to whether we should renew."

Participation of company personnel in particular organizations, or in outside groups generally, also waxes and wanes. "We have staff people at our various subsidiaries who are liaisons," the head of public affairs for a financial services company said: "They watch, and they get materials, and they're not very active. But when a really important, life-and-death issue arises—like allowing banks to get into the insurance business—they really gear up."

Finally, as several executives note, participation can be mutually reinforcing.

- "We work closely with association staff members and ask them to come in from time to time and brief our people on hot issues. Or we'll bring them in, familiarize them with our products and services, and have them visit our plants and laboratories. They get a feel of who we are, and the ties get closer."

"Most outside organizations make it a practice to visit. When they do,I usually invite all our people who are active to take part. We discuss the organization's program, our relationship with it, where the rough edges are, and how to smooth them out. Those of our people who can't attend are asked to send notes, and I bring their comments into the discussion, which is usually quite frank."

Central Management

About half the surveyed companies report that a specific individual monitors, coordinates, or otherwise manages the participation by company personnel in outside organizations. Overwhelmingly—in more than 70 percent of these firms—the central responsibility belongs to an external or public affairs executive, a manager with duties in the area of government relations, corporate communications, public relations, community affairs or the like. If those with corporate contributions responsibilities are included, the ratio

increases to about 80 percent. Even among these firms, however, this centralized management is rarely methodical or thoroughgoing. As table 4 shows, some managing activities are often not performed at all, while the approach to others may be characterized as informal or ad hoc. Executives at a number of firms contrast their "active" or "aggressive" management of organization relations with what they see as a far-more prevalent condition of passivity.

Covering the Bases

Public affairs personnel are tuned into company plans and issues-management systems, follow legislative and regulatory events in Washington, work with company participants on organization boards and committees, and are themselves involved in the work of these groups. They are well-positioned, therefore, to see needs and opportunities for beneficial participation by company experts.

Pfizer's Vice President for Public Affairs says, for example: "As part of the company's operating plan, each division prepares a list of the issues it will be facing during the coming period. All this information is provided to my department. So even though we're a fairly decentralized company, and each division has considerable independence in working with its trade associations, we're able to keep abreast of each division's current and emerging issues. We have a role in trying to coordinate and manage these issues—and much of it is done through third parties, through associations and trade groups."

Where memberships and budgets are tightly controlled by corporate management, participation usually is as well, and public affairs managers tend to have a strong voice. "In effect, I select the people who are to take the key association spots," one Washington office head asserted. More characteristically, the role of the public affairs management is be alert to gaps in representation and to suggest or recruit participants. A public affairs director noted: "We make sure our company is represented on all important association committees—tax, human resources, international trade, technical, and the like—and that our people are properly involved. If we're not represented, or our people are not up to the mark, we go as high as necessary have to get the situation corrected." Another mentioned that when tax policy became an important issue for the company, his department "worked with a key financial executive and helped place him on the tax committee of four associations—one as chairman."

Using Contact Lists

Insofar as the management of organization relations is systematized at all, survey participants report, it is most likely to be in the use of contact lists. Still, they are maintained in only a minority of firms. One type of list maintained by some public affairs directors consists of company personnel who are formally assigned to keep abreast of public policy developments in their areas of expertise or special interest. "We have 120 people who monitor issues or families of issues," one executive reported. "We try to match them with association committees and task forces to see where our company people might serve."

The other most popularly used type of list identifies company managers and professionals who are on the boards, committees, or task forces of outside organizations. "These lists are a management tool," one public affairs vice president observed: "They assure us, when we're dealing with an issue like intellectual property rights or whatever, that we're making maximum use of all the organizations we belong to." Periodic "sweeps" were reported by as a measure to bring lists up to date, though, as one executive commented, "many of the changes are reported to us as they occur." Several of the executives surveyed see such lists in their companies futures. "The growth of computerized personnel systems makes this easier and I think we're moving toward it."

Some government affairs managers say they know the key company people and what they are doing from on-going relationships with them. Or they find out as need arises. One vice president said, for example: "When the investment tax credit issue arose, I went to our leasing company, found out

Is Enough Time Devoted to Outside Groups?

The great majority of executives taking part in this study believe that the time given to outside organizations by their companies' executives is presently about right. A handful believe that an excessive amount of time is consumed. But one in five say that middle managers and professionals devote too little time to these activities, and one in seven say this about senior executives. "We don't manage participation as vigorously as we should," a food company executive says: "In too many cases we're just paying our dues." Inadequate participation is attributed to:

Tight staffing: "Our senior people are too busy as a result of the contraction of managerial layers within the firm," another food company executive reports.

Company policy and expectation: A consumer goods respondent sees a tradition in his company that "tends to delegate participation in organizations to those specifically holding public 'affairs' responsibilities, so that not enough attention is given to public policy involvement at middle manager levels."

Insufficient understanding: "Our managers," one executive reports, "do not have an appreciation of the value of these organizations and the benefits they can bring to the bottom line." Another respondent sees a need to educate managers about such values.

Perhaps reflecting all of these factors, the director of government relations for a Midwest conglomerate says: "Too many managers claim they don't have the time that organizational work having to do with public policy should be the responsibility of corporate communications or public affairs people."

Table 4: Efforts by Corporate-Level Executives to Manage Staff Participation

	Type of Effort			
	Planned/ systematic	*Ad hoc/ informal*	*Rare/ not done*	*TOTAL*
Keep track of which company personnel are involved in the activities of which organization	56%	41%	6%	100%
Keep track of roles company personnel play in each organization	37	55	10	100
Learn what involved personnel judge to be the value to the company of each organization and of their participation	37	53	13	100
Recruit or otherwise influence how many and which company personnel participate in the various organizations	40	42	20	100
Control or influence the roles and activities of company personnel within these organizations	18	51	33	100

Note: Figures add to more than 100% because of multiple answers.
Base: 123 companies reporting that a member of corporate staff monitors, coordinates, or otherwise manages the participation of company personnel in the affairs of membership organizations.

who the key association person was—he happened to be the general counsel—and told him what position we wanted him to take. As it happened, selling him the corporate position and persuading him to sell it to his association colleagues took some doing."

However systematic or informal, the process of matching company personnel against committee structures may reveal voids in the outside organizations as well as in the company's representation. One executive noted, "It recently led, for example, to a realization that tax committees had to be created in five of the organizations to which we belong."

Guiding Participation

Guiding the participation in business organizations of personnel from numerous parts of the company is another role usually played by public affairs management. This entails, first, coordinating the working out of company positions and taking them to their organizations, as issues arise and evolve.[1] One participant explains: "For an upcoming meeting of its public policy committee, one of our associations will send out an agenda, issue papers, option papers, and background data and discussions. Our government affairs people—who have become good about recognizing when there's conflict within the company on an issue, and getting it resolved—will take this material around and, coordinating with the various interested line operations and staff groups, develop a company point of view."

A second guidance task is to ensure that the company's positions and priorities are suitably reflected in the work of the outside organizations' committees and task forces. An executive with coordinating responsibilities in a firm active in the Computer and Business Equipment Manufacturers Association (CBEMA) said: "My job is to make sure company people who participate in the association's many specialized committees are addressing the right issues, doing the necessary staff work, trying to get a consensus on important issues, and moving the issues along when they get stalled in committee. I call these committee people up—poll them—three or four times a year to find out about these things. We also have a review meeting every December. Each committee member reports on what's going on, what the stumbling blocks are with regard to CBEMA staff, whether the company should continue to participate on the committee, and whether the committee itself still has a valid purpose. The meetings are held in December because CBEMA management reviews the year's activities then with each of the committee chairmen, assessing the problems and prospects, and also the quality of staff and member company participation."

Many public affairs executives are able to recount instances of improper behavior on the part of company participants in outside groups. "We're a fairly disciplined organization," one of them says, "and everyone knows we have a very centralized public affairs function. But once in a while someone steps out of line. Just the other day we had to throw a blanket over one of our people, who, as we learned almost by accident, was to be part of a trade association delegation that would call on a Congressman to advocate a position we hadn't even discussed. Moreover, our rule is that nobody calls on Congressmen but members of my department—period, no exceptions."

One company faced the need to indoctrinate all personnel engaging in trade association activities. Meetings were held until recently, the firm's vice president for government affairs reported first, to disabuse them of the idea that the company does not engage in politics; second, to impress upon them the importance of courteous and decorous behavior in their organizations; third, to encourage and show them

[1] See Seymour Lusterman, *Managing Federal Government Relations, The Conference Board, Report No.905, 1988.*

how to cultivate friends and allies. The need for such meetings is no longer felt, this executive reports, largely because the company's response to recent government actions affecting it has made clear to all management's interest in effective advocacy: "We've been mugged by reality."

Coordination

To facilitate liaison with public affairs, and coordinate the activities, of company personnel within an organization, many companies designate "lead" executives. The head of

Industry Relations: Goals of AT&T

- Provide leadership within associations and seek out chairmanship and other demonstrable leadership roles for AT&T managers.
- Develop managers who are capable of making distinctions among a variety of alternatives by choosing those that provide longer term satisfaction of our client groups and AT&T, while recognizing AT&T's earnings requirements and the shorter-term realities required to achieve longer-term results.
- Manage and protect proprietary information and curtail any illegitimate exposure of AT&T business plans in external activities.
- Negotiate positions with key associations and business groups that improve our mutual levels of cooperation and understanding enabling more beneficial use of AT&T's time, energy and dollars.
- Develop stronger linkages with AT&T managers participating in associations/ business groups to ensure accurate and timely feedback
- Increase the enthusiasm of External Affairs' people in the performance of their roles and enhance their ability to cooperate with and stimulate others to achieve.
- Manage areas of agreement with associations and business groups by demonstrating AT&T's willingness to share in and support common objectives in order to isolate areas of disagreement or misunderstanding. Help direct dialogue and resolution.
- Pursue a calculated course of coalition building, expanding upon the relationships of one group into another
- Expand the view of AT&T External Affairs managers to encompass the AT&T enterprise and work on outputs that domestrate negotiation, patience, and intelligent appreciation of other viewpoints.
- Enchance overall AT&T enterprise's image among customers, competitors and partners through direct involvement in face-to-face association activities, i.e. committees, special projects, membership development and issue handling strategy and tactics.
- Develop information and intelligence systems that allow shared access to information needed to perform the External Affairs' roles.
- Seek to mitigate redundant association issue(s) resolution by purposefully influencing each association to target issue(s) each is uniquely equipped to handle.
- Play a missionary role to AT&T groups and external association groups that focuses on winning through cooperation.
- Support the overall goals and objectives of AT&T. Provide intelligent input to the development of AT&T's goals and objectives.
- Raise the corporation's appreciation of External Affairs personnel in order to provide more complete interdepartmental and inter-business-unit career development programs and opportunities for personal growth.
- Educate and improve our internal AT&T appreciation of external contacts, especially association, coalition and key business relationships, by breaking down prior barriers to cooperation.
- Provide balanced support for AT&T Executives who hold association Board of Director positions and plan with them the transition process for their individual replacements as their tenure/commitment is completed.
- Develop an understanding of and input to business-unit objectives and their accomplishment, where applicable, through Association memberships and direct business-unit committee participation.
- Stimulate idea development and innovative approaches to reaching our goals. Always use constructive criticism *not* destructive criticism both with individuals and team.

government affairs at Hewlett-Packard, explained: "Where feasible, the lead is someone in a general executive role. More often, it is a corporate staff member or other division executive. Who gets the assignment depends on how important the organization is and who among the company participants is interested and available. Sometimes the decision is made by the executive committee; sometimes I make a recommendation or request." In some companies, a senior-level executive who has been designated to take the lead role may assign operational duties to an aide.

Public or government affairs personnel also carry coordinating responsibility in some firms, particularly those with multi-member Washington staffs. The head of one such unit observed: "We have people in charge of each organization who watch every committee and council to make sure we're speaking with one voice—something that's not always possible." Another stated: "For an upcoming meeting of its public policy committee, one of our associations will send out an agenda, issue papers, option papers, and background data, and discussions. Our government affairs people—who have become good about recognizing when there's conflict within the company on an issue, and getting it resolved—will take this material around and, coordinating with the various interested line operations and staff groups, develop a company point of view."

Coordination may combine informal with more structured approaches. At Becton-Dickinson, for example, about 25 people participate in the work of the Health Industries Manufacturers Association (HIMA), the firm's principal trade group. "There has been no problem about keeping informed on what they're doing, or letting them know what else they should be doing, because I'm talking to them every day," the company's public affairs director commented. "That's the great advantage of being based at company headquarters rather than Washington. It may not be 100 percent effective, but there seems no sense in developing very cumbersome structures to gain an added margin." A structure can be created, however, around a specific issue in one sector of the company. This is a committee composed of one representative from each of the sector's divisions, created to work with the public affairs director, and to help him understand the implications for the firm of various policy options and develop suitable positions. "I'll meet with these people several times quickly, and then, when we're rolling, quarterly," this executive says.

Where more than one division is involved in the same organization, conflict may arise on policy directions. One government affairs director observed: "It's not always clear who's responsible. In theory, each organization is the responsibility of the line or staff executive most directly involved. But several divisions may be vitally interested in the programs of the same group." Another noted that difficulties also arise when a more senior executive than the one nominally in charge sits on an organization's board.

A company's public policy efforts must often be coordinated among several business organizations—first, to promote congruence in the positions taken by each on an issue; second, to ensure that their respective lobbying efforts are effectively integrated. A public policy association coordinating committee meets every six weeks at AT&T for this purpose. It is made up of the external affairs staff members who manage relations with the company's outside groups and key committee members who are drawn in as needed. Inter-organization coordination is rarely this structured, however. One public affairs director said: "Company positions on important issues are developed by our Public Policy Committee and are pretty well known. When several associations get into the same issue, it's just a matter of making sure our committee people know the company's position, and keeping in touch with them on a day-to-day basis to work out strategies."

Recent Change

Fueled largely by cost pressures and restructurings, many companies are taking a hard look at their outside affiliations. Seventy-two percent of the firms surveyed reported that over the 1985-1988 period they undertook "thorough and critical" reappraisals of their membership budgets and of each organization's value. Some reported that annual reviews, are now more disciplined. For several, this means "thinking strategically"—measuring the potential value of memberships and affiliations against company goals, and determining what is necessary to realize their possibilities. Others are concerned principally with cutting costs. "Memberships are getting high-level attention these days," an auto company executive says: "Management wants to make sure that none is redundant or ineffective—and that we get some real bang for our buck."

Reductions

Lowered earnings, changes in product mix, divestitures, and new managements, have prompted overall reductions in membership budgets by some firms, or the elimination of groups thought to have lost value or to now provide too little benefit. (See Table 5.) Cuts over the 1985-1988 period in one or more classes of the organizations analyzed here were reported by 47 percent of the surveyed firms—cuts in all categories by 10 percent. Some typical explanations:

- "Our corporation has been experiencing severe financial difficulties and all expenditures not essential to its operation are being curtailed."

(A gas and electric utility)

• "We reviewed all memberships last year and dropped any organization that overlapped and duplicated what might be done by another membership."

(A financial services company)

• "Our new owners are not affiliated with, or knowledgeable about, our industry. They are strictly venture capital—bottom-line oriented."

(A manufacturing company)

• "A post-merger review resulted in the elimination of duplications and the strictest reconsideration of needs."

(A diversified energy company)

Increases

Membership budgets have grown more often than they have decreased among firms surveyed. Growth in company size and greater product diversity as a consequence of mergers and acquisitions, are two important reasons. Twice as many firms report that mergers and acquisitions have led to budget increases as that divestitures have produced decreases.

Internally generated growth has also been a factor. "Our orientation was local but has become national," a high-tech company executive reports in explaining bigger trade association budgets.

Second, and equally important in contributing to membership budget growth, has been a fairly widespread increase during recent years in top-management's concern with public policy issues and support for government relations efforts. "Management has become convinced that federal policy decisions will continue to matter a lot: It has supported staff increases in the public affairs department and provided more dollars for think tanks, single-issue groups, and other outside organizations," a manufacturing executive reported.

Finally, many reports of budget growth are explained simply by dues increases—both the "reasonable, inflation-driven increases," in a utility executive's words, levied on their members by most organizations and the increases inherent in assessment formulas. "We're paying more," a pharmaceutical executive says, "because our earnings and workforce have grown."

It is worth noting however, that budget increases at some firms during the past three years come in the wake of earlier cuts, with current budgets still below peak year levels.

Net Results

The net effect of these various influences is that budgets among surveyed companies have changed as follows:

Budget changes (1985-1988)

Increases for all types of organizations	19%
Increases for one or more types, little or no change for the others	24
Little or no change for all types	10
Decreases for one or more types, little or no change for the others	8
Decreases for all types of organizations	10
Increases for some types, decreases for others	29
Total	100%

All types of organizations have not fared equally well. Trade associations have gained more often than any of the other groups. The public policy study groups, in particular, have lost support almost as often as they have gained it. (See Table 5.)

Changes in employee participation in the activities of outside organizations have, for the most part, gone hand in hand with changes in budgets. Where dollars are up, participation usually increases as well, and vice versa. "We can't participate if we don't belong and won't belong unless our people are ready to participate," one executive commented.

Overall Business Support

Most organizations expect a fair degree of turnover in their memberships. Even a rapidly developing group like the American Electronics Association (AEA) lost, by the end of a recent year, ten percent of the firms it had at the year's start—though twice as many new firms joined. Still, despite the preponderance of budget increases found in this study, many organizations have experienced significantly diminised support in recent years. There are several reasons for this.

• Mergers and acquisitions. (They account, for example, for half of AEA's losses in a recent year.) Sliding scale fee structures prevent most of these groups from recapturing all of the income lost to mergers. So, too, do the limits placed

Table 5: Changes in Company Budgets (1985-1988)

Membership budgets have:	*Trade Assns.*	*General Business Orgs.*	*Single Purpose Orgs.*	*Public Policy Study Groups*
Increased appreciably	18%	5%	9%	7%
Increased somewhat	38	40	29	26
Changed slightly or not at all	23	33	39	39
Decreased somewhat	11	12	13	15
Decreased appreciably	5	9	10	13
TOTAL	100%	100%	100%	100%

by management at some of the new and larger firms on the size of membership fee increases.

• Existing organizations face increased competition for corporate dollars as more specialized groups come into existence. A communications company executive says: "Every year there's a new issue, and every year a new association is popping up somewhere or spinning off." A pharmaceutical company executive illustrates:

> "There is an increasing involvement of scientific and professional organizations in the realm that once belonged exclusively to trade associations. About five years ago, for example, the National Academy of Engineering started doing studies on the competitiveness of specific industries; the Institute of Medicine has established programs to look at issues like technological assessment—how we can do a better job of appraising the consequences of new technologies. Such groups are making a legitimate claim on our support, often with new leadership and an understanding that the academic community, business, and other groups in our society are facing the same issues."

• Certain industries have been hurt by shrinking markets and foreign competition, even as others are thriving, and their trade associations have fared comparably. "Reductions in our workforce, plus the need to reduce discretionary spending, have led to diminished participation in all organizations," a steel company executive reports.

• Individual organizations have lost—or gained—members as a result of changes in the character or quality of their services, changing of member-company needs, or closer member scrutiny of the match between costs and benefits. A financial executive commented: "Our company is more selective. It focuses on fewer organizations that are more productive on issues of interest."

Changes in the Value of Organizations

At least half of the study participants believe that their companies get the same value today as several years ago from the organizations making up each class. Most of the others say that the value they derive from these groups has increased. Trade associations, which have gained the most budget support, are rated most highly in this respect (Table 6).

Changes in value are sometimes connected with changes in the organizations themselves—that is, in the scope, character, or effectiveness of their services. More often, however, they are attributed to changes in the company's need for and interest in the organization's services. Thus, for example, 41 percent of those reporting that trade associations have become more useful in recent years say the improvement is due to greater company involvement in the affairs of these organizations, or to more use of their services. Thirty-eight percent say they have more need for the services. Improvement in the organizations' services explains the increased value for only 18 percent of the firms.

A company's membership policy is also influenced by the costs involved. Most organizations employ subscription-support formulas geared to assets, earnings or the like. Some formulas are adhered to strictly; others, in one executive's terms, can be bent. Firms often negotiate terms or simply proffer lesser amounts than those prescribed, and may refuse to join groups that are inflexible in their dues requirements. "Supplementary support," on the other hand, amounts over and beyond those prescribed may also be provided. And support levels for some groups are explicitly voluntary. Thus, the director of a computer equipment company reported that at his firm, money follows participation: "the more we are involved in agenda-setting in any group, the more money we contribute."

Entire classes of organizations are seen by some company planners to have changed in their relative value over the past few years and corporate dollars have been reallocated in the interest of "better targeting." An insurance company, for example, eliminated or drastically reduced support for all organizations but its trade associations. An equipment manufacturer is giving more support to single-issue coalitions, while reducing or freezing fees to a few general business organizations."

Evaluations

In the face of recent changes in company budgets, participation levels, and value received from the organization, how do survey respondents, most of them their companies' senior public affairs executives, appraise current support levels? Eighty-two percent consider them about right, with the dissenters split about evenly among those who consider budgets to be excessive and those who consider them insufficient.

Four out of five of these executives also rate top management's basic understanding of the role these organizations play in the public policy arena as either good (55 percent) or excellent (26 percent). A sizeable majority also approves the manner in which company dollars and managerial time are allocated among particular organizations or types.

Table 6: Changes During Recent Years in Value to the Company

Value has . .	Trade Assns.	General Business Orgs.	Single Purpose Orgs.	Public Policy Study Groups
Increased in all or most cases	17%	4%	8%	4%
Increased more often than not	29	26	30	20
Remained about the same	50	53	53	60
Decreased more often than not	3	14	8	10
Decreased in all or most cases	1	2	2	5
TOTAL	100%	100%	100%	100%

Regional, State, and Local Organizations

The Board's survey also developed some information about local, state and regional memberships, including Chambers of Commerce, manufacturers associations and other trade groups, special coalitions, and business entities formed to advise and aid governmental bodies. Key findings are as follows:

Value to company: According to study participants, benefits derived from membership in non-national organizations are akin to those of national organizations. The principal ones, by far, are executive networking—of opportunities to meet and exchange views with peers form other companies—and public policy data. Public policy benefits include the development of local contacts and grass-roots support. Regional, state, and local organizations differ from their national counterparts in that their reports, publications, meetings, and other activities contribute to much less often to to staffing, organization, and other managerial decisions, or to corporate strategic planning.

Budgeting responsibility: Budgets for these non-national organizations are maintained only in corporate-level departments at 19 percent of the surveyed firms, only in divisional units at 21 percent, and at both levels at 60 percent. This represents a far higher incidence of operating unit responsibility than was found for the national groups. Non-national memberships carried in corporate-unit budgets are usually for headquarters-community organizations. Public affairs or community relations departments maintain these budgets at two-thirds of the surveyed firms.

Recent Change: Like other types of organizations, the category of non-national groups gained business member support over the 1985-1988 period. Reported budget increases for non-national organizations are not as numerous as they are for trade associations, but are well above those for public policy study groups.

Related Conference Board Publications

	Report No.
1. Linda Cardillo-Platzer and Maureen Nevin Duffy, Survey of Corporate Contributions, 1989 Edition	924
2. Seymour Lusterman, Managing Federal Government Relations, 1988	905
3. Ronald E. Berenbeim, Corporate Ethics, 1988	900
4. Kathryn L. Troy, Public Affairs in Financial Services, 1987	899
5. Seymour Lusterman, The Organization and Staffing of Corporate Public Affairs, 1987	894
6. Seymour Lusterman, Managing International Public Affairs, 1985	861
7. Seymour Lusterman, Managing Business-State Government Relations, 1983	838

R4105-29,84F
8/89

The Conference Board

Current Practices in Measuring Quality

A survey of major U.S. firms reveals how they:

- *organize their quality efforts*
- *assess the profitability of quality programs*
- *link ratings to compensation*

Research Bulletin No. 234

Acknowledgements

Like many Conference Board publications, this research bulletin benefited from the input of many people. Special thanks are due to some of the members of The U.S. Quality Council who reviewed the survey questionnaire and suggested topics for inclusion. Lawrence Schein, The Conference Board's representative on The Council provided many valuable insights and reviewed the manuscript. Also contributing significantly were the following Conference Board staff members: Andrew Ashwell, Roberta Booker, Daphne Boykin, James K. Brown, Carlos Galleguillos, Laura Gross, Rita Jones, Evelyn Samore, Marian Simnor, Roberto Vidal, Kim Wood and E. Kay Worrell.

Method

This report is based on survey data collected in the winter and spring of 1989. A questionnaire concerning quality programs was mailed to the chief financial executives of 800 large U.S. corporations and 149 usable replies were received. In part these executives were targeted because a number of key questions dealt with financial and accounting matters. However, since many questions related specifically to quality, recipients were urged to incorporate the views of quality management executives in completing the questionnaire. Because of the specialized nature of the subject, senior corporate quality executives, members of The Conference Board's U.S. Quality Council, participated in the questionnaire's preparation. The distribution of responding firms by lines of business was:

Manufacturing companies (durable goods)	52
Manufacturing companies (nondurables)	44
Nonfinancial service organizations	34
Financial service organizations	14
Combination of lines of business	5
Total	149

Distribution by annual sales or revenues:

$5 billion and over	44
$1 billion to $5 billion	66
$500 million to $1 billion	30
Less than $500 million	4
Not disclosed	5
Total	149

Most responding companies (126) are parent corporations.

© 1989 The Conference Board, Inc.

THE CONFERENCE BOARD, INC.
845 Third Avenue, New York, N.Y. 10022
THE CONFERENCE BOARD OF CANADA
255 Smyth Road, Ottawa, Ontario, K1H-8M7, Canada
THE CONFERENCE BOARD, INC.
Avenue Louise, 207 Bte 5, B-1050 Brussels, Belgium
THE CONFERENCE BOARD, INC.
1755 Massachusetts Avenue, N.W., Suite 312, Washington, D.C. 20036

Current Practices in Measuring Quality

by Francis J. Walsh, Jr.

Until a few years ago, when U.S. business began to perceive foreign competition as a more serious threat, quality was taken pretty much for granted. Most companies did not have broad quality programs. More typically, quality considerations arose in the context of manufacturing as, e.g., the need to inspect and test parts and assemblies on a production line. But the growing influx of competitive imports perceived by consumers to be of superior quality to those domestically produced forced a radical reappraisal of quality. This, in turn, led to the recognition that quality concerns are as important in service industries as in manufacturing, and that quality awareness should apply throughout a company's organization, not only in areas that directly affect customers.

Today, a growing number of companies make a concerted effort to eliminate error from the design, production, marketing, distribution, and servicing of all kinds of products and services. Many executives now believe that quality performance and continual quality improvement are the keys to the productivity, profitability—and even the survival—of much of U.S. business as it struggles with foreign competitors to win increasingly knowledgeable customers. In the words of Professor David Garvin, "Quality has moved from being inspected, controlled, and 'built in' to being managed."[1]

Because this new, broad approach, called variously "quality management," "total quality," and "continuous quality improvement," is relatively recent, it raises many questions; some of which this research bulletin attempts to answer. For example: (1) How sophisticated are the quality programs now in place in large U.S. corporations? (2) To what extent is quality improvement linked to performance appraisal and compensation? (3) How do companies with quality programs measure the results and assess the costs of their quality efforts?

- Of the 149 participative firms, 111 currently have a quality process or program. Of the 38 that do not, 13 plan to institute one.
- Firms with quality programs are concentrating on the more advanced levels of the quality process, e.g., quality management (as opposed to the more traditional concepts of inspection and control); quality improvement through teams or project groups; process improvement; and combinations of these approaches (sometimes called "total quality systems").
- Indicating the commitment to quality, executives in charge of quality are typically at high levels in their companies. Most frequently (in 41 firms) the quality executive reports to an executive, or senior, vice president. In 33 firms the reporting relationship is to the chief operating officer.
- Quality improvement staffs in the surveyed companies are not large. In more than half (64) of the responding firms executives in charge of quality processes have seven or fewer managers or professionals reporting to them. In 15 of these cases, the quality executive has no subordinate managers or professionals.
- Exactly 100 of the survey participants have established quality training programs. These programs are concentrated most heavily at the managerial level, but substantial numbers of production/maintenance/service workers and administrative/clerical personnel have also had quality training.
- Out of the 111 respondents with quality programs, 78 extend them to their suppliers.
- Quality program implementation is an element of *performance appraisal* for managers in 90 companies. But at the administrative/clerical and production/maintenance/service levels fewer than half apply this standard. When it comes to *compensation*, 66 of the companies take quality program implementation into consideration when rewarding managers; far fewer do so for other employees.
- The techniques for measuring the overall results of quality programs are not yet well-developed. The chief measures used, in descending order, are: customer perception of quality of goods or services; profitability; productivity; employee morale; and market share.
- Of the 62 firms that attempt to measure the results of quality on profitability, 47 say that profits have increased noticeably because of lower costs and/or because of increased market share.
- Most respondents say that quality efforts do not conflict with their companies' short-term profit goals.
- Eighty-three companies attempt to measure quality costs—the costs of quality failures or defects (noncompliance costs) and the costs of trying to avoid them (compliance costs).
- The majority of the companies that attempt to measure quality costs compile quality information and statistics outside of the accounting system.
- Senior corporate executives are the largest audience for quality cost information. Heads of business units (divisions and subsidiaries) are another important group.

[1] Daniel A. Garvin, "Managing Quality," 1987, New York, The Free Press, Chapter 2.

The Quality Effort

A broad approach to quality appears to be in place in many large U.S. corporations. To assess the degree of sophistication in quality improvement attained to date, the responding executives were asked to select a term from the list below that best describes their companies' quality management efforts.

	No. of Companies
Inspection	1
Quality control	10
Quality assurance	15
Quality management (embraces approaches to quality that go beyond the traditional levels of inspection, quality control and assurance.)	31
Quality improvement through teams/project groups	19
Process quality improvement	20
Combination of higher levels of quality management (a total quality system)	15
Total	111

Ranging from the most elementary to the most advanced level, the responses of the 111 firms with quality programs are concentrated in the higher levels of the quality process. Fewer than one out of four position their programs at the more traditional levels of inspection, quality control, and quality assurance.

Typical of the comments of surveyed executives whose firms have embraced the total quality approach is this observation from the chief financial officer of a consumer products company:

"In our company,

- Corporate quality plans and goals, with accountability assignments, are established through five-year plans.
- The quality improvement process is integrated within the management system.
- Interdepartmental problem-solving teams are assigned to monitor trends and determine progress toward meeting quality goals."

The quality executive of a pharmaceutical products firm explains how quality improvement is evolving in his company:

"Although most of the company's quality management effort is currently affected by 'quality improvement through teams/project groups,' large portions have progressed to 'process quality improvement.' As in most organizations that have developed quality management initiatives, the quality assurance function continues to exist in this company with its traditional role. There are currently no plans to integrate quality assurance with the quality management initiatives, and distinct roles have been defined for each."

Eighty-seven of the 111 companies having quality programs describe them as being company-wide. The remainder are limited to certain units or parts of the organization.

Executives Responsible for the Quality Effort

The responding companies assign leadership of the quality effort to a variety of executives. By far the most common, reported by 38 firms, is Director or Manager of Quality (naturally, with some slight variations in wording or punctuation from one company to another). Next most frequently mentioned, by 16 companies, is Vice President, Quality (again, with variations). Six companies name a vice president or senior vice president, with no area specified, as the executive in charge of quality management; and five companies say their president is in charge. In some companies responsibility is said to be centered in the "executive team."[2]

The backgrounds or disciplines from which these executives came to their quality management positions likewise show considerable variety. The most common backgrounds of quality executives are:

	No. of Times Mentioned
Manufacturing/production	66
Finance	29
Research and Development	9
Quality Control	8
Planning	6
Construction management	4

The executives in charge of quality typically report to a high-level executive in the companies participating in this survey—well over 40 percent to the chief executive, chief operating officer, or president. The most frequently mentioned reporting relationships are:

	No. of Mentions
Executive or senior vice president (where a function is designated, it is operations more often than not)	41
Chief executive officer	33
Chief operating officer	13
President	3
Division or group president	3
Division or group vice president	3

[2] Other executive titles found among the responding companies included the following: Chairman, Chief Executive Officer or Chief Operating Officer;Executive or Senior Vice President with responsibility for functions such as operations, management, technology, R&D, product integrity and environmental protection; Vice President with responsibilities in the above areas, plus finance, marketing, refining and transportation; General Manager; Director of functions such as customer relations or services, human resources, regulatory compliance and merchandising services.

Less frequently mentioned reporting relationships include vice presidents or other executives in charge of functional areas such as operations, manufacturing, human resources and marketing.

Ninety-two of the survey participants provided information on the number of full-time quality managers and professionals who report directly to the senior quality executives. Here is the summary:

	No. of Companies
None	15
1–3	17
4–7	32
8–12	13
13 and over	15
Total	92

Training for Quality

Most of the survey participants with quality programs (100 out of 111) have established quality training programs. In these companies, a substantial percentage of people at various levels in the organization have been trained in quality concepts, techniques and tools, which differ, of course, from training or development for managing the process.

Companies tend to emphasize training in quality more at the managerial level than they do for other employees:

Percent of class of employees who are trained	No. of Companies		
	Managerial	Administrative/ Clerical Workers	Production/ Maintenance/ Service Workers
90–100%	41	17	28
50– 89%	27	29	28
25– 49%	11	10	13
Less than 25%	16	35	22
No response	5	9	9
No. of companies with training programs	100	100	100

A majority of companies (78) have extended their quality process to include their companies' suppliers. As one financial executive observes: "In the past many of our customer's complaints came about through defects in components we buy from outside vendors. By applying our quality standards to our suppliers, we have largely eliminated these complaints."

Forty participating companies rely to a great extent on their in-house capability to provide training in quality. As one executive in this group observes: "We do a lot of information gathering, then do our own training." A common approach is to start out with external resources, then as the program gathers momentum, switch over to in-house training. The quality executive of a pharmaceutical firm explains: "Up until three years ago, we used both consultants and outside courses. Since that time, we have used an approach developed by our quality management function for use within the company. Any use of external resources is now limited to development of our own designs."

Nevertheless, consultants and outside courses either alone or in combination with internal training programs, play a large role in developing quality programs. Seventy-three companies report this approach. The outside sources specifically mentioned are: training programs offered by consultants who specialize in the quality field; university courses (especially in the field of statistics); and seminars presented by professional societies. The chief financial officer of a consumer products company lists the outside sources used by his firm:

- "Basic statistical quality and productivity improvement courses for manufacturing processes.
- Experimental design techniques for upgrading existing processes.
- Basic techniques of statistical process control taught by a consulting firm.
- On-site statistical courses taught by a local university:
  —Introduction to Statistical Concepts
  —Statistical Quality Control
  —Design and Analysis of Experiments
  —Regression Analysis."

Performance Appraisal and Compensation

Implementation of the quality management process as an element of performance appraisal is common at the managerial level in the companies participating in this project. But at the clerical and production/maintenance/service levels, fewer than half of the companies have taken this step:

Quality Implementation in Performance Appraisal?	No. of Companies		
	Managerial	Administrative/ Clerical Personnel	Production/ Maintenance/ Service Workers
Yes	90	41	51
No	21	70	60
Total	111	111	111

Twenty-nine of the companies that do not presently include quality program implementation in their performance appraisal systems say that they plan to do so.

A smaller number of companies take quality program implementation into consideration when rewarding their workers than they do in performance appraisal. This is true not only at the managerial level but also at the administrative/clerical, production, maintenance, and service levels:

Quality Implementation in Compensation System?	No. of Companies		
	Managerial	Administrative/ Clerical Personnel	Production/ Maintenance/ Service Workers
Yes	66	26	36
No	45	83	75
No response		2	
Total	111	111	111

But 27 of the companies that do not presently factor quality implementation into their compensation systems say that they will in the future.

Techniques for Quality Improvement

The survey participants were asked to provide information about the specific quality improvement techniques they use. Quality improvement techniques can be divided into the following broad classes:

- Customer requirement definition.
- Translation tools.
- Design and development tools.
- Manufacturing.
- Suppliers and vendors.
- Business process management.
- Customer satisfaction.
- Employee problem-solving groups.

Lists of the tools and techniques in each of these categories that were reported by companies participating in this study are presented in this section. Only those approaches or techniques mentioned by four or more companies in each category are listed.

Customer Requirement Definition

Technique	No. of Times Mentioned
Focus groups	40
Surveys of customers' needs, expectations, attitudes and perceptions by mail and/or telephone. Includes surveys by consultants and in-flight surveys by airlines.	22
Direct contacts with individual customers, including visits by senior executives and technical personnel.	14
Customer and user group councils, forums, panels, advisory groups, and awareness meetings.	12
Use of teams and teamwork between customers and companies.	7
Shopping mall studies, intercepts (exit polls) and interviews.	5
Benchmarking (comparison of a company's performance with that of competitors whose performance is known to be excellent).	4
Analysis of complaints.	4

Translation Tools

Translation tools are sometimes described as intermediate steps between defining customer requirements and incorporating them in the design of products and services. The principal technique in this category is quality function deployment (QFD), a Japanese method of translating customers' needs and expectations into specific product design and manufacturing requirements.[3] QFD was mentioned by 43 of the surveyed companies.

Design and Development Tools

Competitive benchmarking, mentioned by 25 respondents, and Taguchi designs, reported by nine firms, are the most frequently encountered design and development tools. Taguchi designs are methods of experimentation and analysis that attempt to relate user and manufacturing viewpoints to one another.[4] Designed experiments are mentioned by five companies.

Manufacturing

Statistical process control (SPC) is the most frequently mentioned (by 29 companies) quality improvement technique in the manufacturing category. SPC applies statistical sampling procedures to the improvement of quality in manufacturing processes. Other approaches mentioned less frequently include: just-in-time methods, failure analysis, and in-process inspections.

Suppliers and Vendors

Evaluation (rating) is the most frequently cited tool for quality management as it relates to outside suppliers and vendors of items that go into a company's products or services. Seventeen companies report that they do such evaluations. Five companies mentioned certification of vendors.

Business Process Management

Forty-eight companies state that they rely on statistical methods to manage quality performance in their business processes.

Customer Satisfaction

Many of the techniques used by companies to manage quality in defining customer requirements are used also to improve quality in customer satisfaction. Surveys and focus groups, the most frequently used tools in customer requirement definition rank one and two in the customer satisfaction area as well. The same can be said of other approaches: direct contacts with customers, customer and user group councils, and analysis of complaints. Many of the customer requirement definition tools that were less frequently mentioned were also reported in connection with customer satisfaction.

Approaches less frequently mentioned in connection with customer satisfaction are: company publications emphasiz-

[3] Lawrence P. Sullivan, "Policy Management Through Quality Function Deployment," *Quality Progress*, June 1988, p. 18.
[4] Phillip J. Ross, "The Role of Taguchi: Methods and Design of Experiments in QFD," *Quality Progress*, June 1988, p. 41.

ing quality that are distributed to customers; comparison shoppers; sales force meetings; and warranty reduction task forces.

Employee Problem-Solving Groups/Teams

Companies participating in this research project take considerable pains to involve their employees in the quality effort. Thirty-eight use surveys of their work forces to gauge workers' attitudes toward quality. Next most frequently mentioned (by 37 firms) as a tool or technique is the formation of quality improvement teams. Quality circles are found in seven companies and meetings of various kinds (management-employee sessions and brainstorming) are reported five times. Some less frequently mentioned approaches are: awareness programs; data bases; obstacle identification; and suggestion programs.

Other Methodologies

Some companies mention quality management techniques that do not fit in the above categories:

- Corporate goal: "to become number one in our industry."
- Replacing quality improvement objectives with specific plans.
- Aim for continuous improvement in everything.
- Comparison of operations with industry data assembled by consultants.

Measuring Quality Efforts

Because the broader concept of quality is relatively new to U.S. business, techniques for measuring the overall results of quality programs are not yet well developed. Yet, as this section demonstrates, many companies are making a valiant effort to measure the impact of their quality efforts on customers' perceptions, company profitability, productivity, employee morale, and market share. Here is a summary of how many participating firms with quality programs (and that supplied information on this point) do or do not attempt to measure such things:

Effects of Quality Programs on:	Attempt to Measure	Do not Attempt to Measure
Customers' perception of quality of goods/services	85	24
Profitability	62	39
Productivity	62	41
Employee morale	57	46
Market share	36	62

Responding companies employ the following techniques to assess the effects of their quality programs:

To measure customer perceptions:

- Satisfaction surveys (the most common approach).
- Feedback from customers, including interviews, executives' visits, and salespersons' field reports.
- Information developed in customers' focus groups.
- Complaint statistics.
- Billing adjustments granted to customers.
- Standards of service (airline).
- Warranty analysis.
- Benchmark studies (i.e., comparison of one's own performance or results with that of a competitor whose performance is known to be excellent).
- Comparison of shipping dates vs. customers' requests.
- Reports of product tests.

To measure profitability:

- Reports of quality costs (see Exhibits 1 through 4 on pages 10-14 for some examples). (Including, for example, the cost of complaints, scrap, waste, and rework.)
- Financial reports to management (sometimes presented on control charts)—e.g., net income before and after taxes, profit margins, operational cash flow.
- Ratio analysis of financial reports (e.g., return on equity, return on invested capital, return on sales, net income before taxes as a percent of sales).
- Cost/benefit analysis.

To measure productivity:

- Statistics on yields, throughput, volume, efficiency, etc.
- Inventory turnover.
- Value of production.
- Statistics on labor output.
- Overhead trends (improved quality may result in lower overhead).
- Ratio of production costs to revenue.
- Cost reports of various kinds.
- Downtime.
- Schedule compliance.
- On-time delivery.
- Time and money saved on projects.
- Production cycle time.

To measure employee morale:

- Summaries and reports of attitude surveys (by far the most common).
- Analysis of information derived from focus groups and other employee feedback.
- Results of one-on-one interviews.
- Statistics on turnover, absenteeism, complaints, and suggestions (favorable trends indicate probable improvements in quality).

To measure market share (based on the assumption that improvements in quality will result in a greater share of the market):

- Business and industry statistics.
- Surveys.
- Market analysis.
- Contracts won and lost.
- Consultants' studies.

Effects on Profitability

Many of the 62 firms that attempt to measure the effects of their quality programs on company profitability (other participants say their quality programs are still too new to be able to measure quality effects on profitability.) concede that such measurements are difficult to do and the results tend to be inconclusive. As one respondent observes: "The dynamics of business do not allow pinpointing profitability as a result of one specific variable such as quality." Another adds: "I think we know the potential (of quality) to impact the bottom line... but we are not yet at the point of being able to measure the results."

Nevertheless, in response to a set of questions, the 62 companies that attempt to measure such effects report the following:

- Forty-seven say that profits have noticeably increased because of lower costs arising from the prevention of errors and defects and/or because of increased market share growing out of improved quality of products and service.
- Fourteen find that profits have remained largely unchanged despite the presence of a quality effort.
- Finally, only one company finds that profits have noticeably decreased because of increased costs of providing higher quality products and services.

External conditions of course, strongly influence the level of an individual firm's profits; but as a petroleum executive observes, quality efforts can have noticeable effects on costs: "Oil industry profits are dependent on world political and economic decisions. This impacts profits far more than quality control. However, quality control translates into effective cost control that allows one refiner to outperform another."

Quality and Short-term Profit Goals

The responding executives overwhelmingly reject the idea that quality efforts conflict with their companies' short-term profitability goals. Ninety-five out of the 111 participating firms with quality programs share this belief. Their reasons may be summarized as follows:

- Contrary to expectations, many quality improvement projects yield paybacks quickly—often within one year.
- Poor quality is expensive; it drives away customers and reduces profits.
- Quality enhances efficiency and productivity. It reduces a company's investment in work-in-process inventories and generally enhances profits.
- Higher quality products command higher prices.
- Improved quality reduces recall and product warranty costs. ("Doing it right the first time equals lowest cost.")
- Many quality improvements cost very little.
- Cost savings from quality improvements often exceed the costs of the improvements.

The minority of survey participants who believe that quality programs do adversely affect short-term profitability do not necessarily disagree with the above arguments. However, they cite the following in rebuttal:

- Quality is essentially a long-term consideration that is designed to improve competitiveness. In the long run it does reduce costs and increase customer satisfaction. But for the short-term, the costs of training and other outlays involved in starting a quality program tend to reduce profits.

One executive believes that short-term needs, as, e.g., to deliver a shipment on time, can cause quality considerations to be set aside temporarily.

Lost Customer Goodwill

Only a minority of the surveyed companies, 35 out of 111, attempts to measure or estimate the cost of lost customer goodwill though quality failure. Admittedly, this is a difficult element to isolate and analyze, and the measurements used are pretty much the same as those listed under customer perceptions and market share beginning on page 7.

Of the companies that do not measure the cost of lost customer goodwill, several have tried and have abandoned the effort because of imprecise results; for example, some do not consider customer surveys to be reliable. One respondent states: "We have given up trying to quantify this cost. As an internal rule, we estimate it as five times our warranty adjustment cost." And the quality executive of a consumer products company adds: "We are not concerned with the cost of lost customer goodwill. We do, however, stress very heavily the need for hard data to measure our customers' perceptions and our competitive position."

Measuring Quality Costs

"Quality costs" is a relatively new term and until recently it was not very often seen in accounting literature. Essentially, quality costs are the costs of quality failures or defects or the costs of trying to avoid them. Eighty-three of the 111 responding firms that presently have a quality process or program attempt to measure quality costs.

Kinds of Quality Costs

Although there is no standard terminology to describe the various classes of quality costs, the following labels and their meanings appear often in quality management publications[1] and were used in the survey questionnaire for this project:

- *Prevention costs*—costs of preventing errors and defects, e.g., in the design of products and services, training, and standards development.
- *Detection costs*—sampling, inspecting, and testing of completed work.
- *Internal failure costs*—essentially the costs of correcting errors before the product or service reaches the customer. Includes cost of scrap, reworking of defective production, downtime, and administrative failures.
- *External failure costs*—cost of correcting errors after the product or service has been delivered to the customer. Includes cost of fulfilling warranties, product liability costs, repairs, and information failures.

Not all of the 83 survey respondents that attempt to measure quality costs do so for all of the above cost categories. Here is the frequency with which each type of cost is measured:

	No. of Times Mentioned
Prevention costs	71
Detection costs	72
Internal failure costs	80
External failure costs	71

For example, according to the controller of a chemical manufacturing company: "We use the Crosby notion of price of conformance (POC) and price of non-conformance (PONC). We break this up in terms of seven PONC categories and one POC category. PONC categories include: yield/usage, supplier-related, customer-related lost sales, excess working capital, rework, and all others."

A vice president, manufacturing, of an automotive products company explains why his firm does not attempt to measure quality costs:

"We try not to get hung up on measurement for the sake of measurement. We believe in our system and would rather use it to solve problems than report history."

A quality management executive of a chemical manufacturing company adds: "We have totally abandoned all measures of poor quality. People feel threatened by these measures."

Reporting Quality Costs

For the most part, quality cost measurement systems in the participating companies exist outside of the firm's formal accounting systems. Only 25 of the 83 companies that measure quality costs do so within the framework of their accounting structures. A few others say that some costs are developed within the system and other information is compiled outside of it. The majority of the responding companies accumulate quality cost information and statistics outside of the accounting process.

Regardless of where their quality cost reporting routines are centered, in most of the surveyed firms the financial and controllers' organizations play a strong role in developing such information. Most often they work as part of a team in cooperation with the quality management people and/or the production staff—or at least provide assistance to such specialists. In a few cases, the quality management staff does the job on its own. Some of the surveyed companies employ consultants, one involves the internal auditors.

Senior corporate executives are the largest audience for quality cost information. Heads of business units (e.g., divisions and operating subsidiaries) form another major group, and so do executives with such titles as senior or executive vice president or vice president. Also mentioned are: controllers, quality executives, plant managers, heads of major functions (e.g., manufacturing), quality committees and teams, and in one company the board of directors.

Examples of quality cost reporting formats are given in Exhibits 1 through 4 (see pages 10-14).

Developing Quality Cost Information

Readers seeking detailed information on methods of compiling quality cost information are referred to "Measuring, Planning, and Controlling Quality Costs," by Wayne J. Morse, Harold P. Roth and Kay M. Poston, 1987. National Association of Accountants, 10 Paragon Drive, Montvale, New Jersey 07645-1760. Among other things, this book contains case studies of measurement and reporting practices, including charts of accounts in companies where quality cost reporting is integrated with the formal accounting system.

[1] For example, see Wayne J. Morse, Harold P. Roth, and Kay M. Poston, "Measuring, Planning, and Controlling Quality Costs," 1987, Montvale, New Jersey, National Association of Accountants, p. 2.

Exhibits

Exhibit No. 1 illustrates a monthly quality cost reporting format prepared by the cost accounting unit of an apparel manufacturing company. It sets forth appraisal and prevention costs, internal and external failure costs for the current month and year to date, in dollars and also as a percent of sales.

Exhibit No. 2 is a quarterly and annual report form used by an electrical products company. This firm classifies its quality costs as conformance vs. non-conformance. Conformance costs include training, preventive maintenance, standards development, inspection and verification. Non-conformance costs are basically the costs resulting from errors and failures of various kinds. The total of conformance vs. non-conformance costs equals the total cost of quality.

Exhibit No. 3 illustrates a graphic form of quality cost report used by a durable goods manufacturing company. And *Exhibit No. 4* shows a slightly different graphic summary by another durable goods manufacturer.

Exhibit 1

An Apparel Manufacturer

COST OF QUALITY
(MONTH)

PREPARED BY: COST ACCOUNTING
DATE:

	CURRENT MONTH		YEAR TO DATE	
APPRAISAL & PREVENTION COST	DOLLARS	% OF SALES	DOLLARS	% OF SALES
	$		$	
Q.C. – Lab				
Q.C. – Apparel				
Q.C. – Fold Inspection				
Textile Inspection				
TOTAL APPRAISAL & PREVENTION				
INTERNAL FAILURE				
Garment Writedown				
Garment Scrapped				
Textile Rework/Scrapped				
Apparel Labor				
Clean/Repair/Mend				
Refold				
Recut Cutter				
Recut Followup/Handling				
TOTAL APPAREL LABOR				
TOTAL INTERNAL FAILURE				
EXTERNAL FAILURE				
Cost of Repairs/Replacements				
Return Goods Clerk				
TOTAL EXTERNAL FAILURE				
TOTAL COST OF QUALITY				
Distribution:				

Exhibit 2

An Electrical Products Company
COST OF NONCONFORMANCE BY GENERIC CATEGORY
FOR THE QUARTERS INDICATED

SCHEDULE A

Generic Category	Latest 4 Quarters Hours	Latest 4 Quarters % to Sales	3rd Quarter, 1988 Hours	3rd Quarter, 1988 % to Sales	2nd Quarter, 1988 Hours	2nd Quarter, 1988 % to Sales	1st Quarter, 1988 Hours	1st Quarter, 1988 % to Sales	4th Quarter, 1987 Hours	4th Quarter, 1987 % to Sales
Failure Investigation Corrective Action/Scrap/Waste Rejects										
Time reported										
100% Departments										
Work-in-Process Scrap										
Finished Scrap										
Carrying Cost-Excess Inventory										
Carrying Cost-Past Due Receivables										
Purchase Discounts Lost										
Bad Debt Expense										
Rework/Report Reprocess/Redesign										
Time Reported										
100% Departments										
Expediting										
Time Reported										
SUMMARY – COST OF NONCONFORMANCE										
Time Reported										
100% Departments										
Work-in-Process Scrap										
Finished Scrap										
Carrying Cost-Excess Inventory										
Carrying Cost-Past Due Receivables										
Purchase Discounts Lost										
Bad Debt Expense										
TOTAL COST OF NONCONFORMANCE										
TOTAL COST OF CONFORMANCE (SCHEDULE B)										
COST OF QUALITY										
COST OF QUALITY EXCLUDING FINISHED SCRAP										

Exhibit 2 (cont.)

An Electrical Products Company
COST OF CONFORMANCE BY GENERIC CATEGORY
FOR THE QUARTERS INDICATED

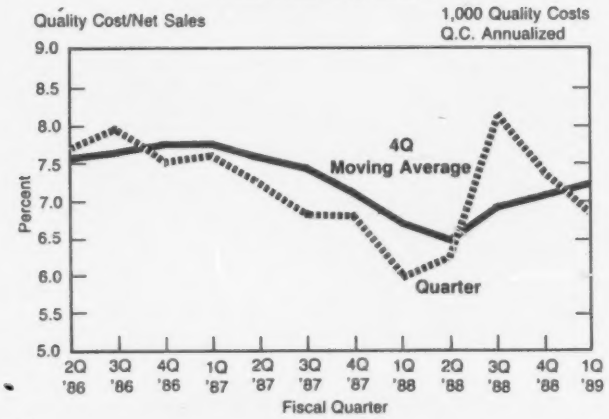
SCHEDULE B

Generic Category	Latest 4 Quarters Hours	Latest 4 Quarters % to Sales	3rd Quarter, 1988 Hours	3rd Quarter, 1988 % to Sales	2nd Quarter, 1988 Hours	2nd Quarter, 1988 % to Sales	1st Quarter, 1988 Hours	1st Quarter, 1988 % to Sales	4th Quarter, 1987 Hours	4th Quarter, 1987 % to Sales
Testing/Evaluation/Analysis/Auditing										
Time reported 100% Departments										
Training/Education/Instruction										
Time Reported 100% Departments										
Preventive Maintenance										
Time Reported										
Standards										
Time Reported 100% Departments										
Inspection/Verification/Review/ Checking/Proofreading Time Reported 100% Departments										
SUMMARY–COST OF CONFORMANCE Time Reported 100% Departments										
TOTAL COST OF CONFORMANCE (TO SCHEDULE A)										

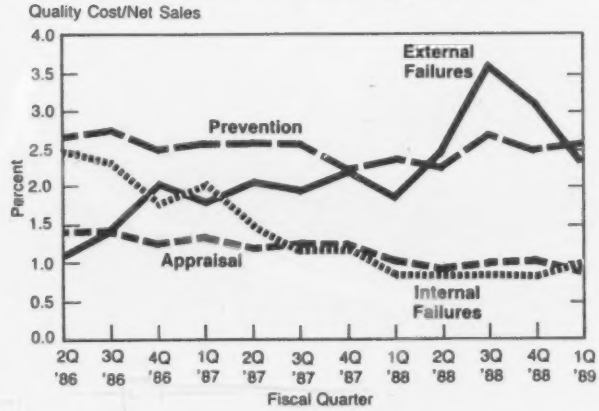
Exhibit 3

A Durable Goods Manufacturer

Total Quality Costs



Components of Quality Costs



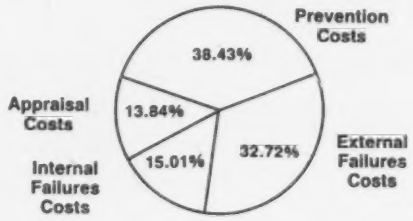
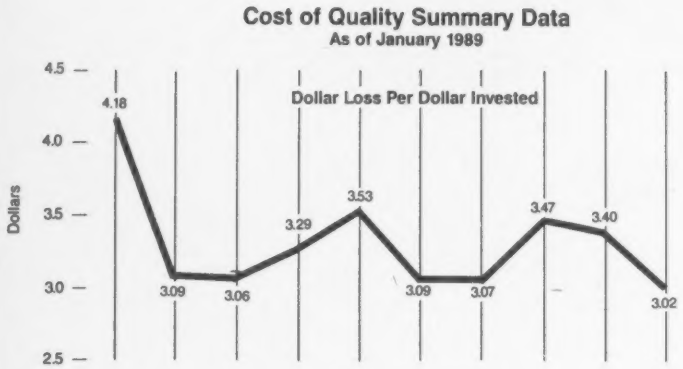
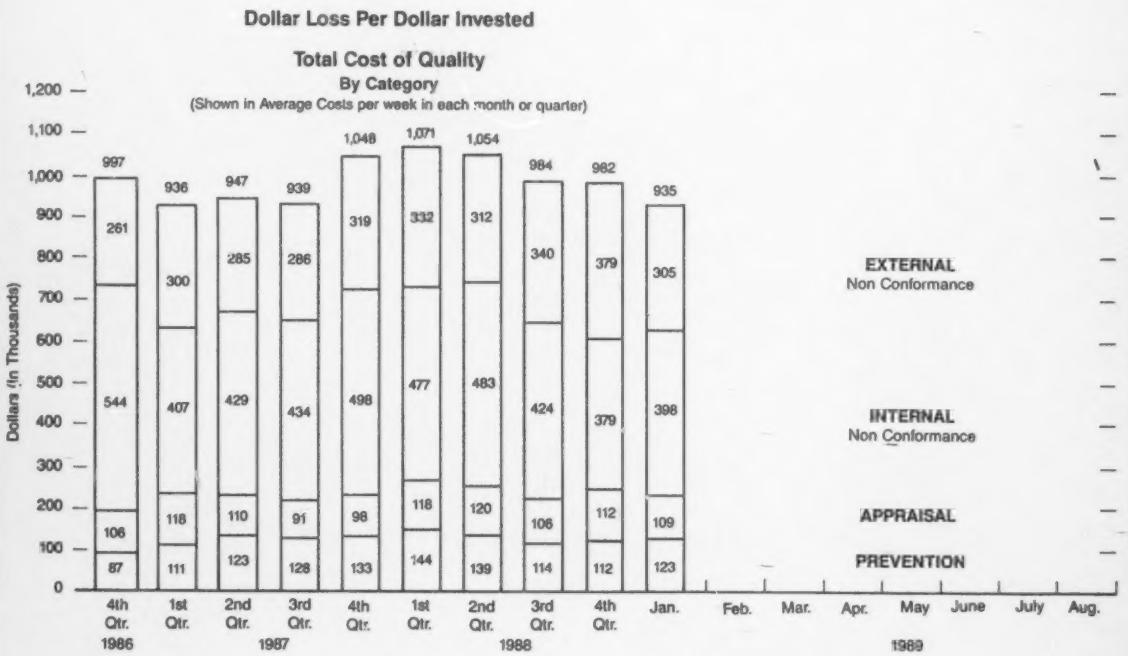


Exhibit 4

A Durable Goods Manufacturer





Related Conference Board Publications

Total Quality Performance: Highlights of a Conference, Research Report No. 909, edited by Lawrence Schein and Melissa A. Berman, 1988.

Quality Language: Defining the Customer-Driven Company, prepared by the European Council on Quality, 1989. Published by The Conference Board in Europe.

R4105 - 29.85 F
8/89

The Conference Board

Corporate Leveraging and Financing Plans: 1989-1992

How U.S. and European Companies:

- *employ debt in capital structures*
- *calculate capital costs*
- *maintain fixed-charge coverages*
- *view capital availability*
- *plan to finance operations*

Research Bulletin No. 235

Acknowledgments

Anthony C. A. Myers, F.C.A., advised on the formulation of the survey instrument and conducted all overseas interviews. Jason Frietag and Roberto Vidal, under the direction of E. Kay Worrell, provided analytical programming for the project. Evelyn Samoré and James K. Brown conducted editorial reviews of the manuscript. And John von Brachel furnished production assistance.

My special thanks to each for his or her contribution.

PJD

© 1989 The Conference Board, Inc.

THE CONFERENCE BOARD, INC.
845 Third Avenue, New York, N.Y. 10022
THE CONFERENCE BOARD OF CANADA
255 Smyth Road, Ottawa, Ontario, K1H-8M7, Canada
THE CONFERENCE BOARD, INC.
Avenue Louise, 207 Bte 5, B-1050 Brussels, Belgium
THE CONFERENCE BOARD, INC.
1755 Massachusetts Avenue, N.W., Suite 312, Washington, D.C. 20036

Corporate Leveraging and Financing Plans: 1989-1992

by Patrick J. Davey

Highlights

Not many years ago some members of the business community looked with disdain on the use of long-term indebtedness. Earmarks of such financing—high cost, riskiness, and restrictions on freedom of action often imposed by borrowing covenants—cast it as a pariah.

But gradually resistance faded. The lure of tax deductibility of interest payments, inflation protection, deterrence of takeover attempts, and enhancement of share earnings offered by borrowings proved largely irresistible. Eventually, convinced that debt's advantages more than outweighed its disadvantages, many major enterprises included a measure in their capitalizations.

Recently, however, controversy has arisen over further increasing the debt content of capital configurations. Detractors fear that taking on additional obligations will only increase already heavy refunding burdens, perhaps making them unbearable in the event of a prolonged economic downturn. Boosters, on the other hand, believe higher debt translates into lower capital costs, thereby strengthening competitive positions, and fosters greater efficiency by riveting management's attention on cost-saving, profit-producing efforts.

This report, the fifth in a series dating back to 1968, updates earlier findings, including those on leveraging and debt-servicing practices, capital costs, and financing plans. In addition, it contains, for the first time, experiences from abroad.

Among the major survey findings:

- Long-term debt continues to play an important role in the capital structures of surveyed companies. Some respondents specifically endorse the practice of leveraging by fixing lower limits on the portion of debt that must be included in capitalizations.
- Coverage of fixed charges is deemed adequate by a large majority of queried firms. Their annual pretax income is two or three times as great as repayment obligations.
- The cost of capital is declining overall for queried U.S. companies. But the median cost of capital is more than two percentage points higher for U.S. than European participants.
- Debt financings are expected to predominate as external funding sources for companies on both sides of the Atlantic during the next several years. Equity offerings do not figure prominently in financing plans.
- Respondents are optimistic about financing prospects through 1992. Only about one-fifth of them express any concern about securing needed funding at a reasonable cost.

Method

Replies to questionnaires from senior U.S. and European financial executives provided much of the information for this report. The queries directed to U.S. and European companies varied somewhat, mostly to allow for differences in accounting methods and the generally greater sensitivity of European companies to disclosing certain kinds of information. Additional input was garnered from interviews with a number of U.S. and European participants.

A total of 150 corporations—125 from the United States; 25 from Europe—contributed to this survey. (See following industry profile of respondents.) Inquiries had been directed to 1,000 companies—850 in the United States, 150 in Europe. U.S. respondents have been classified into six groups. Groups A and B are manufacturing companies. The companies comprising Group A have annual sales of less than $500 million. The companies in Group B have annual sales in excess of $500 million; almost five out of six of them have yearly revenues of more than $1 billion. Groups C, D, E, and F are nonmanufacturing companies of various kinds. With few exceptions, concerns in these four groups are among the volume leaders in their respective industries. All but six of the 125 U.S. companies are publicly traded.

To avoid distortion, responses from several other U.S. companies were excluded from tabulations. Each had recently been involved in a leveraged buyout (LBO) and so was very heavily debt laden.

Europeans participants have been divided into two classifications: manufacturers and nonmanufacturers. The 17 manufacturing companies transact yearly sales ranging from just over $1 billion to well over $30 billion. Annual sales of the eight nonmanufacturers range from $500 million to $8 billion; seven of them transact sales in excess of $1 billion annually. Headquarters for the 25 companies are: United Kingdom (8), Germany (4), Netherlands (3), Sweden (3), Switzerland (3), Finland (2), Austria (1), and France (1). Ownership of two of these organizations is private.

Industry Profile of Participants

U.S. Respondents

Group	Industry	No. of Companies	Percentage of U.S. Companies
A	Smaller manufacturers	19	15
B	Larger manufacturers	64	51
C	Utilities	15	12
D	Wholesale/retail firms	10	8
E	Transportation companies	8	7
F	Service companies	9	7
	Total	125	100

European Respondents

Industry	No. of Companies	Percentage of European Companies
Manufacturers	17	68
Nonmanufacturers	8	32
Total	25	100

Despite qualms about reliance on borrowings, arising largely from the assumption of demanding repayment schedules, most companies opt for blended capital structures. Typically, they decide that a combination of debt and equity best suits their needs. And on occasion, they see fit to vary the proportions of the ingredients in the capitalization mix to allow for changing management tastes.

Formal Reviews

More than four out of five of the 125 U.S. domestic respondents formally reexamine their capital structure goals from time to time. Some conduct these studies at regular intervals—yearly or twice yearly, most often. For example, an executive of a participating manufacturer comments: "The capital structure is actively managed and goals are reviewed annually with senior management to ensure they remain appropriate in view of the changing business environment and corporate objectives."

But others examine their targets only occasionally or as needed. Those that do not schedule regular evaluations are by no means oblivious to the importance of capital structures. Rather, they prefer to rely on existing debt-equity relationships or on ad hoc adjustments as circumstances—takeover attempts, for example—dictate.

Capital structure target reviews are conducted in various ways. Many companies undertake them as part of their long-range planning process. Others depend on their finance, executive, or management committees to manage them and recommend alterations. In a few cases corporate capitalization configurations are considered by the entire board of directors.

But regardless of how or when they are accomplished, the purpose of these reviews is to ensure that capital structures are conducive to the achievement of overall corporate objectives. Explaining why a participating manufacturer makes regular comparisons of the fit between its capital structure and strategic plan, the company's vice president-treasurer offers three fairly representative reasons: "to analyze sensitivity to various operating performance scenarios; to adjust goals to respond to growth opportunities; and to assure access to all capital markets."

Internal and External Influences on Capital Composition

Various developments, both internal and external, are expected to influence capital structures during the next four years, according to the surveyed firms. Important among them are:

- Restructurings;
- Financings;
- Stock repurchases;
- Business results and conditions; and
- Inflation trends.

Restructurings of one kind or another will eventually be reflected in the capitalizations of some surveyed companies. (Just how many will be affected is uncertain, as restructuring plans in many instances are only tentative.) The outcome will be determined by what is done and how it is accomplished. Acquisitions based on borrowings will add to the leverage of some, of course. In other cases, divestitures will result in debt reductions if proceeds from sales of unwanted units are used to retire outstanding obligations.

Expansion programs calling for heavy capital expenditures will require numerous companies to approach capital markets, as will other profit-making opportunities. Conditions within individual companies as well as economic prospects and market conditions, especially the level of stock prices and interest rates, will prompt the selection of equity, debt, or a combination of the two to produce the requisite funding.

Current financing intentions, when fulfilled, will alter the capital structures of many participants. (These plans are subsequently described in detail.) And financings previously completed will also further reshape capitalizations. For example, exercise of convertible provisions attached to certain debt issues may, in time, alter existing debt-equity relationships.

A growing number of companies have adopted stock repurchase programs to acquire shares for executive stock options, incentive plans, acquisition efforts, or per share earnings enhancement. Whatever the purpose, the buying back of shares serves to reduce the equity portion of capitalizations, at least temporarily.

Business conditions and results will affect the capital structures of many respondents. For example, several firms projecting less than rosy economic prospects and reduced profitability intend to decrease their reliance on long-term debt financing. But others, forecasting rising cash flows and higher profits, plan to take the opposite tack. Where industry outlooks are uncertain or gloomy the tendency is to boost dependence on equity.

Some of those queried expect inflation to influence capital structures to some extent over the next four years. But others do not, believing its impact will be confined to costs, not capital proportions. For the most part, participants expecting continuing or rising inflation to influence capital configurations foresee a shift in emphasis toward the use of debt because of the prospect such a move offers for repayment in "cheaper dollars."

Several participants believe other developments, such as takeover attempts, will have implications for capital structures. According to these prognosticators, unnegotiated cash tender offers will prompt many targets to institute defensive man-

euvers, including the addition of debt to capitalizations. Expectations with regard to currency valuations and tax regulations are also expected to encourage appropriate shifts.

Debt Ratios

At the heart of capital structure design is the issue of how much debt to include. As already noted, most companies go beyond basic equity financing. From time to time they increase or decrease percentages of long-term indebtedness to adjust the "pure vanilla" flavor equity contributes to capitalizations. Conclusions on selected financing combinations are reflected in debt ratios (see accompanying box).

The median current debt ratio for the 119 U.S. companies providing this information (three companies have no long-term debt; three others did not furnish the information) is 34.9 percent, a modest rise from the median of 33.5 percent found in the 1981 Conference Board study.[1] The following tabulation affords a comparison of median debt ratios for the component groups then and now.

Median Debt Ratios	*1981*	*1989*
Group A (smaller manufacturers)	27 percent	30 percent
Group B (larger manufacturers)	28 percent	30 percent
Group C (utilities)	51 percent	47 percent
Group D (wholesalers/retailers)	37 percent	40 percent
Group E (transportation firms)	39 percent	48 percent
Group F (service companies)	Not available	33 percent

While strict comparisons between 1981 and 1989 have to be viewed with caution because of differences in companies contained in the two samples, the data suggest a gradual increase in debt reliance during the eight-year period. However, the actual order of debt ratios displayed by the groups is hardly changed over the period; the reversal of positions of utilities and transportation companies atop the list is a noteworthy exception. Also exceptional is the decline in the median debt ratio of utilities.

A frequency distribution of the existing debt ratios of participating domestic companies appears in Table 1 (see p. 6). It shows that manufacturing companies are at the lower end of the scale; almost three-quarters of the companies in both Group A and Group B report debt ratios of less than 40 percent. Transportation and utility companies (Groups E and C) are less equity intensive; debt ratios equal or exceed 40 percent for more than half the companies in each of these categories.

Why the discrepancies? Profitability patterns, financing approaches, cash flows, and other critical factors vary from industry to industry. Common traits usually promote the creation of similar capital structures among companies in a given line. Thus, for example, manufacturers subject to the whims of the business cycle are more likely to curtail the level of debt in their capitalizations than utilities. In general, utilities enjoy more dependable income expectations, have lower exposure to economic downturns, and are therefore capable of employing debt more extensively.

Debt Ratio Calculation

The debt ratio may be computed in several ways. To ensure uniformity, those queried were requested to calculate it as follows:

$$\text{Debt ratio} = \frac{\text{total long-term debt}}{\text{total long-term debt plus net worth}}$$

Survey respondents were asked to include all long-term obligations whether or not reflected on balance sheets in determining the ratio. Short-term indebtedness of all kinds is excluded from this computation, even though it may figure prominently in the calculation of the debt/net worth ratio used to compare the respective stakes of creditors and owners in a business.

Recent reliance on long-term borrowings has varied among U.S. participants. During the past five years, debt ratios climbed for 49 companies, declined for 43 others, and went little changed (or the direction of change went unreported) for the remaining 27 with debt in their capitalizations.

Acquisitions are the most frequently cited cause of increases in debt ratios. Many respondents borrowed to finance the purchase of other organizations, thereby adding to the level of debt in their capitalizations. Also contributing to heavier reliance on debt were expansion-related loans, operating losses (which, of course, eroded equity), and share repurchase programs.

Debt repayment, either through profits or asset sales, or both, accounted for the bulk of declines in debt ratios. Issuance of common stock also played a role.

Limits

Fifty-eight U.S. participants impose constraints on the percentage of long-term indebtedness that may be contained in their capitalizations. Of these, 32 fix both upper and lower limits; 22, upper limits solely; and 4, lower limits only.

Sixty-seven respondents do not set limits on debt as a percentage of capitalization. But the absence of formal bounds does not indicate license. Some simply prefer to keep a careful watch on debt ratios during reviews and to not define limits as long as existing and projected levels are deemed prudent.

Table 2 (see p. 6) indicates that debt limits on percentages of indebtedness in capital structures tend to be higher in nonmanufacturing than in manufacturing companies. But the difference is less pronounced now than when the Board looked at debt limits in 1981. Then, the upper limits of surveyed manufacturers showed a 35 percent median vis-a-vis the just over 40 percent median reflected currently. Perhaps the strong economic performance of recent years diminished fear of vul-

[1]Patrick J. Davey, *Corporate Capital Structures and Financing Plans: 1981-1984*, The Conference Board, Information Bulletin No. 97, 1981.

Table 1: Debt Ratios of 119 U.S. Companies

Debt as Percentage of Total Capital	No. of Companies						
	Group A	Group B	Group C	Group D	Group E	Group F	Total
Less than 10%	4	5	0	1	1	1	12
10-19%	1	8	0	0	1	2	12
20-29%	2	16	0	1	1	1	21
30-39%	4	19	2	3	0	1	29
40-49%	4	9	6	0	1	1	21
50-59%	1	2	4	3	1	1	12
60-69%	0	2	3	1	1	1	8
70% and higher	0	0	0	1	2	1	4
Total	16	61	15	10	8	9	119
Median Percent	30	30	47	40	48	33	34.9

Table 2: Upper Limits on Debt in Capitalizations

Upper Limit of Debt as Percentage of Total Capital	No. of Companies						
	Group A	Group B	Group C	Group D	Group E	Group F	Total
10-19%	0	1	0	0	0	0	1
20-29%	0	2	0	0	0	1	3
30-39%	1	9	0	1	1	0	12
40-49%	3	14	3	1	0	0	21
50-59%	1	2	3	1	2	0	9
60-69%	0	2	0	1	0	1	4
70-79%	1	1	0	1	1	0	4
Total	6	31	6	5	4	2	54
Median percent	40.8	40.1	46.0	55.0	53.75	42.5	41.5

nerability to business downturns and helped narrow the gap between the debt caps of manufacturers and nonmanufacturers.

The 36 companies that set lower limits on the percentage of debt that may be included in capital structures (Table 3) specifically endorse the practice of leveraging. To greater or lesser degrees they seek to reap the benefits of debt reliance by implicitly capping the level of equity that may be employed. Now, as in 1981, utilities set the highest minimums on debt percentages—no doubt a reflection of their relative immunity to economic declines and fairly-strong assurance of adequate cash flows.

How do companies fix limits? Formulas are seldom used. Most often concerns that establish debt limits employ methods similar to those that are used in setting capital structure targets (subsequently discussed). Indeed for some "limits" is a misnomer; "guidelines" is more descriptive because the percentages designated are flexible and can be violated with some impunity when worthwhile opportunities arise. At any rate, whether limits or guidelines, the percentages established are usually responsive to concerns about ratings, risks, and rewards.

Basically most companies take a fairly conservative approach to setting limits and settle on percentages that afford them comfort. They choose limits that permit them to reap the benefits of indebtedness but avoid the pitfalls of overly burdensome interest charges. Guiding one respondent, for instance, is the belief that the company "should use some leverage for its shareholder earnings growth potential but leave ample room to service and repay borrowings in any climate."

Among European participants, leveraging or "gearing," as the practice of relying on long-term borrowings is often called, is quite popular. Usage resembles that of U.S. firms, with virtually all European respondents dependent upon gearing to some extent. Extremes are generally avoided, with equity levels maintained at 30 percent or more—usually much more—in all cases. Several set a 50 percent cap on the level of indebtedness that may be included in capital structures but indicate that this top is not ironclad. Penetration of the lid in unusually inviting circumstances is tolerated.

Planned Changes In Debt Ratios

At least 61 of the 119 U.S. companies now employing leverage to some degree intend to alter their existing debt ratios by 1992. Plans call for 25 to boost debt levels to a degree that will place them in a higher category and for 36 to decrease debt ratios enough to place them in a lower category. Thirty-six plan no change or one of insufficient magnitude to affect their present category. The remaining 22 either do not make or did not provide forecasts. Table 4 reflects the target categories participants have set for their debt ratios in 1992.

Only four of the 45 companies with current debt ratios of less than 30 percent intend to lower them, whereas 18 with such ratios plan increases. On the other hand, 32 of the 74 companies whose present debt ratios exceed 30 percent plan to lower them, while only seven in that category intend to raise them.

As in the past, those planning to lower debt ratios hope to shore up financial shortcomings, thereby improving credit standings and easing access to capital markets. Conversely, companies intending to expand the use of leverage believe the addition of debt will bolster per share earnings as well as lower capital costs.

Provided present plans pan out the median debt ratio of the 97 companies, furnishing forecasts will drop to 30.5 percent by 1992. (Table 1 indicates that the existing median debt ratio reflected by these companies and the 22 others providing information is 34.9 percent.) The median debt ratio for each of the component groups save D (wholesale/retail firms) is also expected to decline over the next several years as indicated in the tabulation below:

Group	*Existing Median Debt Ratio (Percent)*	*Projected Median Debt Ratio (Percent)*
A	30	25.5
B	30	25.2
C	47	45
D	40	50
E	48	42.5
F	33	25.4

Table 3: Lower Limits on Debt in Capitalizations

Lower Limit of Debt as Percentage of Total Capital	*No. of Companies*						
	Group A	*Group B*	*Group C*	*Group D*	*Group E*	*Group F*	*Total*
Less than 10%	1	0	0	0	0	0	1
10-19%	0	0	0	0	1	0	1
20-29%	2	6	0	1	0	1	10
30-39%	0	9	1	2	1	0	13
40-49%	1	4	3	1	0	0	9
50-59%	0	0	1	1	0	0	2
Total	4	19	5	5	2	1	36
Median Percent	25.0	30.0	44.0	36.25	20.0	25.0	30.0

Table 4: Target Debt Ratios of Participating U.S. Companies for 1992[1]

Existing Debt Ratios	*Projected Debt Ratios*								
	Less than 10%	*10-19%*	*20-29%*	*30-39%*	*40-49%*	*50-59%*	*60-69%*	*70% and higher*	*Not set or no response*
Less than 10% (12 companies)	2	3	3	1	1	0	0	0	2
10-19% (12 companies)	2	2	4	1	2	0	0	0	1
20-29% (21 companies)	0	2	11	2	1	0	0	0	5
30-39% (29 companies)	0	1	9	8	5	1	0	0	5
40-49% (21 companies)	0	0	2	6	8	1	0	0	4
50-59% (12 companies)	0	0	0	1	4	4	0	0	3
60-69% (8 companies)	0	0	1	0	2	3	0	0	2
70% and higher (4 companies)	0	0	0	0	0	0	3	1	-

[1]Consider line four as an aid in using this table. It indicates that 29 companies presently have debt ratios in the 30-39 percent range, and that eight of these companies believe their debt ratios will be in the same range several years hence. Of the remaining 21 companies, 10 expect debt ratios to decline; 6, ratios to rise; and 5 did not provide forecasts.

Table 5. Methods Used to Establish Target Debt Ratios by U.S. Companies

Procedure	No. of Mentions[1] A	B	C	D	E	F	Total
Analysis of cash flows	17	53	10	9	8	5	102
Consultations	9	40	13	10	6	3	81
Consideration of risk	11	36	11	5	7	3	73
Analysis of leverage's impact on profits	12	29	8	6	4	3	62
Analysis of revenue trends	9	30	5	6	5	2	57
Comparisons with capital structures of industry peers	4	29	11	5	3	1	53
Other	1	6	4	3	0	1	15
Total	63	223	62	44	33	18	443

[1]Multiple responses are reflected.

Targeting Debt Ratios

As mentioned, some concerns review capital structures in conjunction with strategic planning exercises. When it appears that existing aggregations of debt and equity are incompatible with expected corporate developments, such as major expansions of facilities, companies start to make adjustments. Table 5 points out the principal methods participants rely on to establish debt ratio targets. Seldom do companies base decisions on a single approach; most prefer to fix goals after applying a number of analytical reviews.

Cash flows rank highest on the list of influences weighed by firms in establishing capital structures. Realizing that liquidity is important to survival, most hesitate to take on debt if forecast cash flows are weak or uncertain. Only when adequate margins exist, as determined by careful comparisons between projected cash inflows and outflows, do the vast majority of companies increase their debt levels.

Consultations with outside experts affect the shape of some respondents' capital structures. Especially important are discussions with investment and commercial bankers, rating agency executives, and security analysts. All are in position to comment on company plans and review their probable impact on credit standings and security prices. And some will offer counsel on capitalization changes.

Fear of default is an ever present consideration influencing the use of debt. So companies are careful to factor this risk into calculations when considering the addition of debt to capital structures. Various ratios, including the fixed charge coverage ratio (see p. 9), are available to help measure such risk and guide decision making.[2]

[2]For a review of the use of ratios in determining financial risks, see Francis A. Lees, *Corporate Debt: Changing Perceptions of Financial Risk*, The Conference Board, Research Bulletin No. 120, 1982.

Companies are also attentive to revenue trends and to the impact of varying amounts of leverage on earnings per share. By constructing break-even charts, analysts can quickly determine whether debt or equity promises the greater return for forecast levels of earnings before interest and taxes.[3] However, earnings projections alone are rarely sufficient to tilt a financing decision one way or another. Only when other tests confirm the wisdom of a given direction do companies opt for debt or equity.

Some companies look at the average debt ratio displayed by firms in their industry and attempt to emulate it. However, this method is not applied indiscriminately. Firms realize that a typical position is not necessarily good for them because unique circumstances may set them apart from their competitors and justify distinctive capital structures. (Industry ratio information for comparative purposes is readily available from a number of sources, including stock evaluation services and credit agencies.)

Despite the application of various methods, there is nothing automatic about the process. Final choices on capital structures may also bear the imprint of management philosophies and tend toward more or less risk (debt), depending on whether senior executives are aggressively or conservatively inclined. In addition, target capital structures are not static; goals are subject to change to match evolving corporate needs.

[3]For a detailed explanation of the use of break-even or indifference charts, see James C. Van Horne, *Fundamentals of Financial Management*, (4th Edition). Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1980, pp. 383-389.

Debt Service

Leveraging, or augmenting the equity investment in a business with long-term debt, is, as just seen, a widely employed practice among survey respondents. Of course, its use obligates debtors to repay lenders in accordance with whatever terms are negotiated. Assistance in assessing a firm's capacity to honor borrowing agreements is often determined by an analysis of fixed-charge coverages.

Fixed-charge Coverages

Owners and creditors are each vitally concerned about a company's ability to meet its fixed charges—interest obligations, lease expenses, and sinking fund payments, primarily—in an orderly fashion. Shortcomings in debt-servicing ability, if revealed or even suspected, can have serious repercussions for companies, not the least of which is sharply diminished access to capital markets. Most strive to avoid such predicaments by taking whatever steps are necessary to protect their credit reputations.

To gauge the potential of responding firms to deal with their repayment commitments, participants were asked to furnish data on their fixed charges relative to their pretax incomes. Table 6 provides the percentages on an industry basis. It presents a more conservative picture of debt handling ability than the traditional coverage ratio, which weighs the relationship between fixed charges and pretax income plus fixed charges (where the denominator is always larger).

The fixed charges of at least 78 of the 125 U.S. participating companies amount to less than 30 percent of their pretax incomes. Thus in more than 60 percent of all cases pretax income affords greater than three times coverage for fixed repayment obligations. And almost 80 percent enjoy better than two times coverage of fixed charges, even using the stricter approach to measurement imposed on respondents.

Higher than typical fixed-charge coverage is exhibited by Group B with three quarters of the component firms enjoying ratios of better than three to one. Half or more of the companies in Groups A, E, and F exhibit similar ratios. But groups C and D lag a bit, with only 40 percent of those in each attaining such fixed-charge coverage.

Possession of a strong coverage ratio suggests a company will show facility in retiring bills but, of course, does not guarantee prompt payments. The absence of a good or better-than-average coverage relationship, in turn, does not necessarily imply weakness or inability to meet obligations on a timely basis. In periods when earnings are poor, losses are sustained, or leveraged buyouts occur (see box p. 10), coverage ratios will be on the low side or nonexistent. Indeed many companies in such straits weather the storm by drawing upon cash reserves, liquidating fixed assets, or making other moves that permit them to maintain satisfactory payment records.

Ratios other than fixed-charge coverages are helpful in determining debt-servicing potential. Especially useful are liquidity ratios, such as the acid test and current ratios; somewhat useful are various kinds of asset turnover ratios.

Table 6: Fixed-charge Coverages in Participating U.S. Companies

Interest and Rental Payments as Percentage of Pretax Income	*No. of Companies*						
	Group A	*Group B*	*Group C*	*Group D*	*Group E*	*Group F*	*Total*
Less than 10%	3	9	2	1	2	1	18
10-19%	3	19	1	0	1	3	27
20-29%	4	20	3	3	1	2	33
30-39%	0	3	2	1	0	0	6
40-49%	2	4	4	1	2	1	14
50-59%	1	3	1	2	0	0	7
60-69%	0	0	1	1	1	2	5
70-79%	0	0	1	0	0	0	1
80-89%	0	0	0	0	0	0	0
90-99%	1	0	0	1	0	0	2
100% and higher	2	0	0	0	0	0	2
No response	3	6	0	0	1	0	10
Total	19	64	15	10	8	9	125
Median percent	21.5	19.6	36.0	39.9	27.0	20.0	20.0

Leveraged Buyouts

Taking public companies private through leveraged buyouts (LBOs) has become very fashionable in the 1980s. LBOs are purchases by small groups of investors, sometimes including members of management, of companies from public shareowners. Basically the purchasing group offers a premium over market price—the size of the premium varies from deal to deal—to existing owners and also assumes outstanding indebtedness.

Financing is usually accomplished with a small down payment and heavy borrowings—some from commercial banks, some from investors in high-yield (junk) bonds, such as specialized mutual funds, pension funds, and insurance companies.

Who profits from these arrangements? Existing shareholders invariably obtain prices in excess of market for their holdings. Lenders also secure above-average rates of return provided all goes as planned. Middlemen, too—arrangers, investment bankers who act as advisers, lawyers, and others—receive substantial fees for their services. And the new owners stand to reap sizable rewards on their leveraged investments provided obligations are paid down and their shares appreciate in value.

Who loses from these deals? Existing bondholders can see the market value of their obligations dip, sometimes sharply, as investors seek compensation (in way of larger returns) for the increased risk assumed in holding the paper of heavily indebted organizations. And other creditors too—bankers, junk bond holders, and suppliers providing trade credit—may lose if such restructured companies do not prove equal to the task of properly servicing their heavy debt loads.

What actually happens? In some cases, the initially large debt position of a company involved in an LBO is reduced over time as pieces of it are sold off. Some of these restructured companies eventually reemerge in the ranks of public corporations.

Are leveraged buyouts successful? The verdict is still not in. Theoretically, leveraged buyouts promote efficiency by holding out a carrot and stick to managers. As owners, the rewards of progress await them in the form of profits; however, the specter of failure haunts them in the guise of demanding repayment schedules. In practice, there have been more triumphs than failures to date. But the test of performance in a hostile economic environment is yet to be administered.

Three surveyed companies which have undergone leveraged buyouts provided their experiences for this report. However, these data are not included in any of the tables or other summaries that appear elsewhere in this report because they are atypical. For example, the percentage of their pretax income that goes to cover fixed charges is 70, 80, and 200 percent, respectively—very high by normal standards.

The executive vice president and treasurer of one of these firms, a manufacturer, states that a great deal of management's time is devoted to the reduction and administration of debt. Considerable attention is also given to capital structure design but with some misgivings because net of goodwill and other intangible assets the net worth of the company is negative.

Trends

Trends in debt-coverage ratios are more telling signals of looming defaults than single readings. When ratios move in a direction indicating weaker coverage over a period of time, alarm bells may be justified.

Table 7 indicates that fixed-charge coverage improved over the past five years for slightly more respondents than those reporting a weakening. Those pointing to better coverage ratios usually cite one or more of the following reasons: increased profitability (higher pretax income) with fixed charges holding constant, interest reductions because of debt retirements or refinancing of high-cost issues, and pretax income growth outpacing growth in fixed charges. Where deterioration occurred, increased interest charges due to boosts in borrowings or jumps in interest rates, pretax earnings declines, and greater reliance on leasing typically carry responsibility.

Creditors and others concerned about a company's ability properly to handle obligations usually examine more than just coverage ratios for telltale signs. Such investigations ordinarily extend, as just mentioned, to checks of other germane ratios and the directions in which they are moving. They also include reviews of profit trends and internal and comparative analyses of financial statements over a period of years. These detailed probes are usually far more revealing than those concentrating on studies of data contained in balance sheets and income statements for any given year.

Sufficiency

How do participants view the adequacy of existing fixed-charge coverage ratios? As Table 8 makes clear, a large majority believe relationships between fixed charges and pretax income are in satisfactory alignment. Strength of ratios vis-a-vis those of peers and industry averages, contentment with bond ratings, and ease with which debt is being serviced are the principal reasons for tranquillity. But some expressing satisfaction see room for improvement and will seek to strengthen these ratios.

Among those dissatisfied with existing coverage ratios, credit considerations are paramount. Convinced that lowering the percentage of pretax income needed to service fixed charges holds the key to better ratings and ease of financing, most of those expressing concern intend to take remedial steps. Comments the senior vice president of a transportation company: "We want to achieve BBB or A ratings on debt to assure access to debt markets under all but the most unusual conditions."

Table 7: Trend of Fixed-charge Coverages for U.S. Participants (1983—1988)

Coverage Trend	No. of Mentions						
	Group A	Group B	Group C	Group D	Group E	Group F	Total
Improved	7	23	8	2	5	2	47
Regressed	5	22	7	4	1	4	43
Held Steady	6	16	0	4	2	2	30
Not indicated	1	3	0	0	0	1	5
Total	19	64	15	10	8	9	125

Table 8: Opinions of U.S. Participants on Adequacy of Fixed-charge Coverages

Views of Existing Fixed Charge Coverages	No. of Companies						
	Group A	Group B	Group C	Group D	Group E	Group F	Total
Adequate	15	54	10	9	5	8	101
Inadequate	2	6	4	1	3	0	16
No response	2	4	1	0	0	1	8
Total	19	64	15	10	8	9	125

Table 9: U.S. Participants' Expectations on Trends in Fixed-charge Coverage Ratios through 1992

Outlook for Coverage	No. of Companies						
	Group A	Group B	Group C	Group D	Group E	Group F	Total
Improve	8	26	9	5	2	4	54
Weaken	3	7	1	1	2	4	18
Remain Constant	8	29	5	3	4	1	50
No response	0	2	0	1	0	0	3
Total	19	64	15	10	8	9	125

Expectations

Domestic participants are optimistic about debt-servicing prospects. Most believe that their coverage ratios will either improve or hold steady over the next several years (Table 9). Only about one company in seven providing a forecast anticipates a decline in its fixed-charge coverage ratio through 1992. Reasons for expectations on improvement or weakening closely resemble those just recounted for coverage trends over the past five years.

Widespread improvements are expected by Groups C and D. Only one company in each of these industries looks for coverage to slip. In Group F, however, almost half of the component companies forecast deterioration in coverage ratios through 1992.

Among European respondents the outlook is similarly sanguine. A majority think forecast improvement in enterprise profitability will strengthen coverage ratios. Several look for a fairly constant trend in coverages while a few expect some softening to occur. One indicates that the possibility of making acquisitions and other developments will determine whether coverage gets better or worse.

Cost of Capital

The cost of capital, or price a company must pay its owners and creditors to secure their financial support, is a matter of much interest and debate. It is a composite of the costs of the equity and long-term debt that comprise a company's capitalization.

Present Corporate Capital Costs

Currently, the cost of capital for the 100 U.S. companies supplying this information ranges from a low of seven percent to a high of 22 percent. The median is 12 percent; so is the mode. Table 10 presents a frequency distribution of capital costs on an industry basis.

All of the firms in Group C report a cost of capital less than 15 percent—a claim no other group can make. What accounts for this distinction? Several possibilities exist, but it is especially significant to note that the median debt ratio of utilities (47 percent), the companies constituting Group C, comes within a single percentage point of being the highest among the various groups represented. (In Group E, transportation companies, where the highest median debt ratio exists—48 percent—four out of the five respondents report a cost of capital less than 15 percent.) The inference is that prudent use of leverage contributes to a lower cost of capital.

What are the costs of capital for European companies? Among ten surveyed manufacturers, the cost of capital ranges from 4.5 percent to 17.5 percent; the median is 10 percent. The cost of capital for seven nonmanufacturers starts at 5.5 percent and ends at 25 percent, with a median of 8 percent. Observations on the existence of differences between U.S. and European corporate capital costs appear in the box on p. 13.

Recent Developments

Declines sharply outpaced increases in capital costs among domestic participants during the past five years (Table 11). In each group, more companies saw capital costs go down than up. These results are somewhat at odds with predictions made by respondents to the 1981 survey who, by a two-to-one margin, anticipated increases in the cost of capital at least through 1984.

Table 12 presents evidence of the descending slope in capital costs noted by participants in recent years. On an industry basis it contrasts median cost of capital percentages revealed in the 1981 survey and the present one. In so doing, it confirms the regressive trend.

Table 10: Cost of Capital in 100 U.S. Companies[1]

	No. of Companies						
Cost of Capital	*Group A*	*Group B*	*Group C*	*Group D*	*Group E*	*Group F*	*Total*
5-9%	2	3	1	1	0	0	7
10-14%	12	30	13	6	4	6	71
15-19%	1	13	0	2	1	2	19
20% and higher	1	2	0	0	0	0	3
Total	16	48	14	9	5	8	100

[1]Computed by respondents using a variety of methods

Table 11: Trends in Cost of Capital Among U.S. Participants (1983—1988)

	No. of Companies						
Direction of Change in Capital Costs	*Group A*	*Group B*	*Group C*	*Group D*	*Group E*	*Group F*	*Total*
Higher	1	7	3	1	2	0	14
Lower	7	25	9	2	3	6	52
Steady	9	22	2	6	1	2	42
No response	2	10	1	1	2	1	17
Total	19	64	15	10	8	9	125

Why the drop in capital costs among U.S. corporations during the decade of the 1980s? While sampling and computational differences (subsequently discussed) may be partially responsible, there are other likely contributors. These include reduced return expectations propelled, importantly, by lower interest and inflation rates, and restructurings, particularly those boosting leverage levels.

Outlook

A majority of domestic respondents expect capital costs to remain pretty stable over the next several years. And, as Table 13 indicates, among the minority predicting change, opinion on its direction is about equally divided.

Generally, those forecasting a fairly constant cost of capital through 1992 plan few, if any, major changes in their capital structures between now and then. Their basic assumption is that the costs of equity and long-term financing will either remain as is or vary in proportions that will leave total costs largely unaffected.

Firms anticipating reductions in capital costs often point to expected lower interest rates as the reason for their position. Planned increases in debt positions and anticipated reductions in the riskiness of their businesses, which would

Table 12: Median Cost of Capital Percentage among U.S. Industries

Industry	*Median Cost of Capital In 1981*	*Median Cost of Capital In 1988*
Smaller Manufacturers	14.3	12.05
Larger Manufacturers	14.0	12.50
Utilities	11.9	11.05
Transportation Companies	16.2	11.25
Wholesalers/Retailers	12.0	11.0
Service Companies	N/A	12.75

Corporate Capital Costs: United States vs Europe

Among 100 surveyed U.S. companies the median cost of capital is 12 percent; that of 17 queried European firms is 9.8 percent. Do these data indicate that European companies enjoy a competitive edge, that is, that they can profitably undertake investment projects that U.S. companies would shun as unrewarding? While sample size and other considerations including accounting differences make such a conclusion chancy at best, the better than two percentage point spread reported suggests that such a possibility exists.

Pointing to the availability of international capital markets, interviewed executives of European companies for the most part doubt that their concerns enjoy lower capital costs. But some think they are tougher negotiators and, thus, occasionally obtain lower rates on borrowings than U.S. concerns. U.S. executives queried on this point believe their European counterparts do have lower capital costs, but less as a result of their bargaining skills as of their gearing practices.

Greater use of leverage or gearing is the reason usually advanced by those who believe that European companies possess lower costs of capital on average than U.S. firms. As noted, the tax deductibility of interest payments makes debt the less costly form of financing. And greater reliance on debt in Europe is said to be more sustainable because of ownership patterns and customs. European banks for example, are both owners of and lenders to many companies—a twin relationship that promotes support even during periods when financial pressures surface.

Are U.S. companies attempting to close the gap? It has been pointed out that over the course of this decade their capital costs have declined. And continuing restructurings, including leveraged buyouts, debt-financed acquisitions, and stock repurchase programs, are increasing debt ratios. But whether these steps will bolster the competitive positions of U.S. companies or redound to their detriment remains to be seen.

Table 13: Capital Costs for 1992 by U.S. Participants

Direction of Anticipated Change in Capital Costs	*No. of Companies*						
	Group A	*Group B*	*Group C*	*Group D*	*Group E*	*Group F*	*Total*
Higher	1	8	3	2	0	0	14
Lower	7	4	1	1	3	0	16
Steady	9	39	10	6	3	8	75
No response	2	13	1	1	2	1	20
Total	19	64	15	10	8	9	125

lower the premiums demanded by investors, are other explanations offered to support this view.

Among those looking for capital costs to increase in the next few years, spurts in interest rates are mentioned as the probable cause. Plans to adjust capital structures by adding to their equity contents are less frequently cited.

But interpretations of developments influencing capital costs occasionally differ. For example, a senior financial executive from a large manufacturing company takes exception to the generally expressed belief that the addition of debt leads to reduction of capital costs. He notes that the "market will likely require higher returns as leverage becomes more prevalent throughout corporations."

Among queried European companies providing views on future trends, a dozen foresee little, if any, change in capital costs during the next several years. Seven of the remaining nine commentators anticipate declines; the remaining two look for increases. Reasons offered to support expectations tend to parallel those advanced by U.S. firms of like persuasion.

Calculation

There is no agreed upon formula for calculating the cost of capital of an organization. Companies that find such an exercise worthwhile employ a variety of methods. Most strive to arrive at a percentage that reflects a weighted average of capital component costs. Computational differences arise mainly from the use of dissimilar methods to determine the price of equity; from reliance on distinct costing bases—embedded or incremental; and from variations in weighting approaches.

Regardless of the method employed, the resulting cost of capital is an estimate at best because assumptions of various kinds enter into its determination. "By all conventional methods its between 11-13 percent" says the vice president-finance of a large manufacturer referring to the company's conclusion on its cost of capital. "To be more precise is a waste of time."

Computing Equity Costs

To determine the cost of equity, or return required by investors, companies on both sides of the Atlantic usually make calculations based on one of several approaches: the Capital Asset Pricing Model (CAPM), historical rate of return, dividend return expectations, and price/earnings reciprocals. (CAPM is the most popular method.) Scant mention is made of the Arbitrage Pricing Theory (APT) or addition of premiums to debt yields as means of costing equity.[4]

The Capital Asset Pricing Model: Basically, companies employing CAPM to determine equity costs act on the premise that the required return (or cost) of equity equals the risk-free rate of return plus a premium for assuming the risks inherent in stocks in general adjusted for the relative risk, or beta, of their own stock vis-a-vis that of the entire stock market.[5] Thus by solving the following equation, they approximate the price of equity:

$$\textit{Equity Cost} = \textit{Risk Free Rate} + (\textit{Risk Premium} \times \textit{Beta})$$

The risk free rate of return may be established as the yield, existing or forecast, for U.S. Treasury bonds or bills, for example. The risk premium or difference between the rate required of stocks in general and the risk-free rate may be determined by studies of historical patterns or projections of future trends. And beta can either be computed internally by the use of comparisons or obtained from external sources that calculate and supply such information. (Here it should be noted that those who supply beta details do not always reach the same conclusion on the beta that should apply to a particular stock.)

As a simplified illustration of the CAPM approach to costing equity, consider the case of a company whose stock is determined to have a beta of 1.5—a volatility level 50 percent greater than that of the market as a whole. Assume that the risk-free rate of return is 10 percent and that the return offered by stocks in general is 14 percent. Then, the cost of equity for the company equals 10 plus (14–10) × 1.5 or 16 percent.

Rate of Return: Several companies view the historical rate of return earned by stockholders as the cost of equity. For instance, a company whose stock rose from $10 to $20 in market price over a 10-year period and which paid a $1 annual dividend during the decade would provide an annual average pretax return of 20 percent to shareowners. This established return is used to approximate the cost of equity in computations to determine an overall cost of capital.

Dividend Growth Expectations: Despite the problems involved in projecting dividend streams—a requisite of this method—some respondents relate the flow of expected future dividends to the market price of their shares to determine a cost of equity. Thus, for instance, a company with shares selling for $25, paying a $2 dividend, and planning a six percent annual increase in payout for the indefinite future might estimate its equity cost by use of the equation:

$$\textit{Equity Cost} = \frac{\textit{Current Dividend}}{\textit{Stock Price}} + \textit{Dividend Growth Rate}$$

$$\textit{Equity Cost} = \frac{2}{25} + .06 = 14 \text{ percent}$$

Price/Earnings Reciprocals: Several queried firms rely on price/earnings reciprocals to estimate equity costs. Price/earn-

[4]For a discussion of APT and CAPM as determinants of risk, see Richard Roll and Stephen A. Ross, "The Arbitrage Pricing Theory Approach to Strategic Portfolio Planning," *Financial Analysts Journal*. May-June 1984, pp. 14-26.

[5]For further examination see, for example, Robert W. Johnson and Ronald W. Melicher, *Financial Management*, (5th Edition), Boston, Massachusetts: Allyn and Bacon, Inc., 1982, pp. 417-421.

ings ratios are determined by dividing a stock's price by its earnings. A company whose stock sells for $36 and is earning $3 a share has a price/earnings ratio of 12 (36/3). The cost of equity for such a company using this method is 8.3 percent (3/36).

Customized Approaches The methods already described do not exhaust the avenues taken to arrive at a cost of equity. Several participants trace their own routes using combinations of standard approaches and tailored formulas suited to special needs.

Take a larger manufacturer, for example. It estimates that the cost of equity consists of the assumed long-term inflation rate plus a small consideration for the volatility of its own stock. Or consider a utility seeking to determine pricing requirements in a regulated environment. It relies on a modified discounted cash flow analysis to measure the cost of equity.

Computing Debt Costs

Interest payments determine debt costs. However, tax deductibility softens the impact of these costs. If, for example, a company's long-term debt carries a 14 percent interest charge and a corporate tax rate of 40 percent is expected, the cost of debt is computed by the equation:

Cost of Debt = Interest Rate x (1—expected tax rate)
Cost of Debt = 14 × .6 = 8.4 percent

Where there are a number of debt issues, a weighted average cost based on the yield to maturity and proportional representation of each issue may be used in the foregoing equation. Similarly, an average rate for floating interest charges may be employed, or, to be more conservative, a rate near or at the top of the potential interest range may serve as the basis for calculation. As for convertibles, companies may rely on their equity costing approach if market prices of relevant shares make debt for equity switches likely. Or conventional debt measurement may be deemed appropriate if an exchange appears only a remote possibility.

Most computational differences that arise derive from rates applied rather than methods used. Although the tendency is to rely on incremental rates—those in effect for present or contemplated borrowings—in making calculations, some use historical or embedded rates. Current rates are easily obtained, even if recent market experience is lacking, by checking on the issues of competitors with like credit standings or asking investment bankers.

Computing Preferred Costs

Possessing both debt- and equity-related characteristics, preferred issues have hybrid qualities. Like debt they are subject to fixed charges; like equity they pay dividends, which are not deductible for income tax purposes either in the United States or Europe.

The cost of an issue of preferred shares is determined by dividing the dividend (fixed charge) by the proceeds from an issue. Thus an issue of $100 preferred shares paying a $12 annual dividend would have a cost of 12 percent. As with other capital components, cost variations appear if embedded rates instead of prospective rates are used in computations.

The Weighted Average Cost of Capital

When all the pieces are in place, they are combined to produce an overall cost of capital for the corporation. This usually means that the relative proportions and costs of capital components are considered in arriving at the weighted average.

Once the costs of equity, debt, and preferred share segments of capitalizations have been determined, the job of weighting each remains. Three options exist: proportions may be based on book values, market values, or targeted capital structures. The choice can have a meaningful impact on the overall cost of capital derived from the ensuing computation.[6] The following tabulation using incremental rates and market weights presents a representative approach:

Capital Components	*Amount (Market Values)*	*Percent of Total Capital*	*After-tax Cost (Projected)*	*Weighted Cost*
Debt	96	40%	8%	3.2%
Preferred Stock	24	10%	10%	1.0%
Equity	120	50%	14%	7.0%
Weighted Average Cost of Capital				11.2%

Capital Costs of Underlying Units

Twenty-one respondents go beyond the calculation of a corporate cost of capital. These companies also determine a cost of capital for subsidiaries and other strategic businesses. Some participants who do not currently pursue this route say they plan to do so.

Why take this approach? Many companies have underlying units with risk and return profiles that set them apart from other divisions and subsidiaries and from the organization as a whole. To improve the capital project selection process and to properly assess the effectiveness of such operations, some deem it appropriate to establish costs of capital for them.

To arrive at divisional costs, some respondents use the same methods they employ to determine corporate costs of capital. But betas for underlying units using the CAPM in computations, for example, may be based on averages for companies in the industry or industries in which they are active. Or the betas may simply be estimated by management using experienced-based judgments.

[6]For illustration of possible variances, see Statements on Management Accounting, Statement Number 4A, Cost of Capital, National Association of Accountants, Montvale, New Jersey, 1984, p. 12.

Table 14: Applications of Cost of Capital in Participating U.S. Companies

Applications	No. of Mentions[1] Group A	Group B	Group C	Group D	Group E	Group F	Total
Setting Hurdle Rates	11	50	12	9	3	7	92
Selecting Financing Approaches	6	27	9	2	4	4	52
Establishing Performance Standards	7	27	6	4	4	3	51
Other	3	6	3	1	2	2	17
Total	27	110	30	16	13	16	212

[1]Multiple responses are included.

But regardless of how divisional costs are determined, there is little gainsaying the value of this refinement.[7] Indeed the senior vice president, finance and accounting, of a transportation company notes, "We compute the cost of capital only by business unit because of its greater relevance at this time."

Applications

Table 14 indicates that among the various ways in which participating companies apply the cost of capital, setting hurdle rates ranks highest. Since the cost of capital represents the minimum return an investment proposal can offer without impairment to stockholder value, most companies establish hurdle rates that exceed their cost of capital. How much higher usually depends on the riskiness of specific proposals or groups of proposals.

Information derived in cost of capital computations, especially as applied to targeted capital structures, proves helpful to some in choosing financing methods. Others employ the cost of capital as a norm for the measurement of performance. Still others find the cost of capital useful in preparing filings for rate hearings before regulatory commissions, arranging bond refundings, analyzing working capital positions, evaluating the effects of restructurings on shareowners' interests, and planning acquisitions and divestitures.

[7]See, for discussion of various approaches, Samuel C. Weaver, et al, "Divisional Hurdle Rates and the Cost of Capital," *Financial Management*, Spring, 1989, Journal of the Financial Management Association.

Fund Raising: Intentions, Potential Problems and Cutbacks

To accomplish strategic plans, most respondents will have to access both the capital and credit markets during the next several years. But some of them also propose to reduce their reliance on external financings.

Long-term Financing Plans

With the exception of eight companies—six manufacturers, one utility, and one service firm—all domestic participants expect to use one or more forms of long-term external financing during the next several years. The eight see little need to raise capital and intend to rely entirely on internally generated funds through 1992.

The companies that intend to tap outside sources between now and 1992 will employ the methods outlined in Table 15. It shows that standard debt issues (bonds) and private placements of debt head the list as financing vehicles. Bank term loans, lease arrangements, and international borrowings will also play important but somewhat lesser parts in fund raising schemes. And the sale of assets is expected to provide wherewithal for more participants than the issue of common shares. Private placements of preferred issues and offerings of high-yield issues (junk bonds) do not figure prominently in the present financing plans of respondents.

Emphasis in terms of probable method usage varies to a considerable degree from industry to industry. For example, larger manufacturers prefer straight bond issues over all other financing approaches by a wide margin. But among wholesale/retail firms, transportation companies, and service companies, private placements are accorded preference.

Despite the substantial increases in share prices since 1982, which, at least on the surface, should boost the appeal of equity sales, most respondents in need of capital plan to shun this vehicle. Only 25 or slightly more than one-fifth of those planning capital raising efforts through 1992 are considering this method. Why? Apparently the perceived advantages offered by various forms of debt offerings hold even greater attractiveness.[1]

Table 16 (see p. 18) ranks the capital raising methods from which domestic participants intend to obtain the greatest amount of long-term funds before the end of 1992. As in the Board's earlier survey, bonds continue as the preferred vehicle. Currently more than half of the participating companies that intend to enter the capital market during the next several years make the issuance of bonds either their first or second choice among the various funding alternatives. Their compelling features—relative ease of refunding, lengthy terms, and acceptable rates, together with the attractive tax treatment afforded interest payments flowing from them—place bonds atop the standings.

Other borrowing approaches—private placements and bank borrowings—follow in the rankings; then come leases and international borrowings. Equity trails, with only high-yield debt following it in the standings.

As might be expected, individual group rankings vary somewhat from overall results. For example, among smaller manufacturers, private placements and bank borrowings outrank all other forms of financing. Size and credit ratings may explain these choices; bond markets are not always receptive to small or lower-rated issues.

All but two participating European companies intend to obtain financing in the capital markets during the next several

[1]For an illuminating discussion of the continuing trend toward debt usage, its implications, and what can be done about it, see Henry Kaufman, "Halting the Leverage Binge," *Institutional Investor*, April, 1989.

Table 15: Planned Capital Raising Approaches by U.S. Companies Through 1992

		No. of Mentions[1]									
Group	Companies in Group	Equity Offerings	Standard Debt Issues	High Yield Issues	Private Placements of Debt	Private Placements of Preferred Issues	Bank Borrowings	International Borrowings	Leasing	Sales of Assets	Other[2]
A	19	5	3	1	11	4	12	3	7	6	1
B	64	8	43	4	24	8	22	20	21	16	6
C	15	6	12	2	7	6	5	5	5	5	0
D	10	2	6	1	7	2	4	2	5	1	3
E	8	3	4	3	7	2	6	2	5	3	0
F	9	1	5	0	6	1	3	2	4	3	0
Total	125	25	73	11	62	23	52	34	47	34	10

[1]Indicates number of respondents expecting to raise funds by category; multiple responses are included.
[2]Includes project financings and asset based financings.

years. The exceptions expect internally generated funds to suffice. Table 17 indicates the approaches these companies plan to take in financing their operations. The pattern displayed is not too unlike that for U.S. companies (Table 15). Debt issues predominate with standard debt issues (bonds), bank borrowings, and international borrowings in the forefront of planned financing activities. Equity issuance figures more prominently on a relative scale among European than U.S. participants, however.

As with U.S. companies, financing methods proposed by participating European firms differ in planned frequency of use between groups of companies. For example, among European manufacturers standard debt issues hold sway as the preferred borrowing vehicle, whereas among nonmanufacturers bank borrowings share the top slot with equity financings.

Table 18 ranks the external sources from which participating European firms plan to raise funds through 1992. Bonds, bank borrowings and international borrowings rank one, two and three, respectively, based on the number of times each was mentioned as first or second choice as the financing vehicle that is expected to provide the most funding. While not the same as the choices of U.S. firms, this order is nevertheless quite similar. The top two selections by each group are identical and the third, though different in each case, is a debt instrument.

Short-term Financing Plans

U.S. participants plan to continue the heavy reliance on commercial paper and bank borrowings, revealed in the earlier Board survey, to handle their short-term financing needs through 1992 (Table 19). During the next several years, if all goes as expected, commercial paper will supplant bank loans as the most frequently used short-term financing vehicle. The rate advantage over bank borrowings enjoyed by such "IOUs" is largely responsible for the anticipated shift. Trade credit, international short-term borrowing, and factoring will also provide, to varying degrees, required financing support.

Table 16: Rankings of Proposed Capital Raising Methods by U.S. Participants[1]

Group	Companies in Group	Equity	Bonds	High Yield Debt	Private Placements of Debt	Private Placements of Preferred	Bank Borrowing	International Borrowing	Leasing	Sales of Assets	Other
		1 2	1 2	1 2	1 2	1 2	1 2	1 2	1 2	1 2	1 2
A	19	0 2	0 0	0 0	5 4	1 1	6 2	0 0	2 2	1 0	0 1
B	64	1 1	29 6	0 1	4 11	1 1	7 7	1 5	1 7	2 3	3 3
C	15	0 1	10 2	0 0	2 2	0 2	1 1	1 1	0 1	0 0	0 0
D	10	0 1	4 2	0 0	2 2	0 0	0 2	0 0	0 2	0 0	0 2
E	8	0 0	2 1	0 0	1 5	0 0	1 0	1 0	1 3	1 0	0 0
F	9	0 0	1 2	0 0	5 0	0 0	2 1	0 1	0 2	0 2	0 0
Total	125	1 5	46 13	0 1	19 24	2 4	17 13	3 7	4 17	4 5	3 5

[1]This table lists only capital raising methods ranked one or two by respondents; it indicates, for example, that 29 larger manufacturing companies rank public offerings of standard debt as their primary approach and six list it as their second most important route to raising external capital through 1992.

Table 17: Planned Long-term Financings by European Participants Through 1992

Type of Company	Companies of Each Type	No. of Mentions[1] Equity Offering	Standard Debt Issues	High Yield Issues	Placements of Debt	Private Placements of Preferred	Private Bank Borrowings	International Borrowings	Leasing	Sales of Assets	Other
Manufacturing	17	6	11	2	8	3	9	10	4	4	1
Nonmanufacturing	8	5	4	1	2	0	5	3	1	4	0
Total	25	11	15	3	10	3	14	13	5	8	1

[1]Number of mentions, regardless of ranking, by respondents.

Table 20 (see p. 20) shows how these participants rank the various short-term financing approaches as potential sources of financing through 1992. Commercial paper not only heads the list on an overall basis with 77 respondents naming it as first or second choice, but also is the most favored financing method for each of the groups save A. The dissidents, small manufacturers, prefer bank loans, trade credit, and international borrowings to commercial paper. Why? A possible explanation is that the commercial paper market is generally less accommodating than other markets to companies of less than substantial size.

Among European companies queried, a somewhat different picture of short-term financing methods emerges (Table 21 on p. 20). Bank borrowings are expected to predominate. Trade credit, holding a slim margin over commercial paper and international borrowings, will also be heavily used to support day-to-day operations.

What is the relative importance of the various short-term financing methods to these respondents? Table 22 (see p. 20) indicates that more than half of them rank bank borrowings as their first or second choice of vehicles from which they expect to obtain the greatest amount of short-term financing during the next several years. Trade credit and commercial paper are in a draw for runner-up, although trade credit has an edge if only the first choice is considered.

While manufacturing firms rank commercial paper over bank borrowings in a tight fit, nonmanufacturers reverse this order by a three to one margin. Nonmanufacturers also rank trade credit on a par with bank borrowings as preferred short-term financing vehicles. Whether these relationships would prevail given a broader sampling of preferences is moot, however.

Possible Funding Difficulties

Queried executives are now much more optimistic about financing prospects than was the case in 1981. Then, fully half of those surveyed thought raising capital over the next several years might prove troublesome.

Earlier in the decade respondents perceived a number of obstacles. Chief among them: heavy demand for funds fueled in part by inadequate depreciation allowances, persistently high inflation and interest rates, lowered credit ratings, especially for some mining and utility concerns, and equity investor disinterest tracing in large measure to low share prices. Most of these potential causes of financing problems, it should be

Table 18: Rankings of Proposed Long-term Financings by European Participants[1]

Type of Company	Companies of Each Type	No. of Mentions[1]																	
		Equity		Bonds		High Yield Debt		Private Placements of Debt		Private Placements of Preferred		Bank Borrowing		International Borrowing		Leasing		Sales of Assets		Other	
		1	2	1	2	1	2	1	2	1	2	1	2	1	2	1	2	1	2	1	2
Manufacturing	17	3	1	6	3	0	1	0	2	2	0	2	2	2	4	1	1	0	0	0	1
Nonmanufacturing	8	0	2	1	2	0	0	0	1	0	0	4	0	0	1	0	1	2	0	0	0
Total	25	3	3	7	5	0	1	0	3	2	0	6	2	2	5	1	2	2	0	0	1

[1]Table lists only long-term financing approaches ranked first or second by respondents.

Table 19: Planned Short-term Financing Approaches by U.S. Companies Through 1992

Group	Companies in Group	No. of Mentions[1]					
		Trade Credit	Bank Borrowings	International Borrowings	Commercial Paper	Factoring	Other[2]
A	19	11	17	10	4	1	0
B	64	20	34	22	47	6	3
C	15	3	12	4	14	3	1
D	10	5	7	0	8	0	0
E	8	3	5	1	5	0	0
F	9	1	4	3	6	0	0
Total	125	43	79	40	84	10	4

[1]Number of mentions in each category, regardless of ranking, by respondents.
[2]Includes receivables discounting and vendor financing.

Table 20: Rankings of Expected Short-term Financing Approaches by U.S. Participants[1]

Group	Companies in Group	No. of Mentions[1]											
		Trade Credit		Bank Borrowings		International Borrowings		Commercial Paper		Factoring		Other[2]	
		1	2	1	2	1	2	1	2	1	2	1	2
A	19	5	3	10	6	1	4	3	0	0	0	0	0
B	64	11	5	7	15	2	10	34	9	1	1	1	1
C	15	0	0	3	8	0	1	11	3	1	0	0	1
D	10	1	3	3	3	0	0	6	1	0	0	0	0
E	8	0	2	3	1	0	1	5	0	0	0	0	0
F	9	1	0	1	2	2	1	3	2	0	0	0	0
Total	125	18	13	27	35	5	17	62	15	2	1	1	2

[1]This table only lists short-term financing methods ranked first or second by respondents.

Table 21: Planned Short-term Financings by European Participants Through 1992

Type of Company	Companies of Each Type	No. of Mentions[1]					
		Trade Credit	Bank Borrowings	International Borrowings	Commercial Paper	Factoring	Other[2]
Manufacturing	17	9	11	9	11	4	2
Nonmanufacturing	8	7	7	4	3	1	0
Total	25	16	18	13	14	5	2

[1]Number of mentions, regardless of ranking, by respondents.

Table 22: Rankings of Proposed Short-term Financing Approaches by European Participants[1]

Type of Company	Companies Each Type	No. of Mentions[1]											
		Trade Credit		Bank Borrowings		International Borrowings		Commercial Paper		Factoring		Other[2]	
		No. of Mentions											
		1	2	1	2	1	2	1	2	1	2	1	2
Manufacturing	17	4	1	5	2	0	6	5	4	0	0	1	1
Nonmanufacturing	8	5	1	3	3	0	1	0	2	0	0	0	0
Total	25	9	2	8	5	0	7	5	6	0	0	1	1

[1]Only approaches ranked first or second by respondents are considered.

noted, either did not arise or were resolved through unforeseen developments, such as the sharp rise in the stock market and the substantial participation of overseas investors in public and private sector security offerings.

Now, as the decade draws to a close, only about one-fifth of participants see the possibility of difficulties confronting their own industries or industry in general in efforts to secure financing through 1992. The principal cause of anxiety is referred to as event risk—a development that would disrupt financing plans. For example, following a leveraged buyout accomplished largely with junk bonds, a company's previously outstanding bonds might be quickly downgraded (because of a diminution of credit worthiness) to a point that would make additional fund raising very expensive, very difficult, or both. Other companies in the same industry might be similarly affected. Even though not involved in leveraged buyouts, investors might view such companies as likely targets and treat their debt securities accordingly.

The director-corporate finance of a utility believes such vulnerability exists. He comments: "Although the telecommuni-

Table 23: Methods Employed by 55 U.S. Participants to Reduce Reliance on External Funding

Method	No. of Mentions						
	Group A	Group B	Group C	Group D	Group E	Group F	Total
Cost Reduction Programs	9	21	11	2	4	1	48
Improved Control of Working Capital	9	24	5	2	5	3	48
Training Seminars	2	3	0	0	0	0	5
Other[1]	2	5	1	0	0	1	9
Total	22	53	17	4	9	5	110

[1]Includes measures to improve performance, increase cash flow, repay or refinance debt and institute asset management programs.

cations industry is not viewed as having sufficient event risk, LBOs and their effect on corporate bond spreads could extend to the utility bond market with the first successful large-scale utility leveraged buyout."

Besides possible problems related to event risk, questions are also raised about the possible impact of interest rate swings, economic trends, developments in the junk bond market, and takeover activity on the financing of operations through 1992. Several respondents fear that high interest rates, if they continue to climb, will make borrowings too expensive. Others believe an economic downturn would create conditions that could close capital markets to highly leveraged firms. A few think junk bond defaults could have unwanted ripple effects on the markets for quality credit. Others wonder about the effects of continued or heightened takeover activity on financial markets.

Several respondents voice industry-specific concerns. A senior financial analyst with an oil company, for example, anticipates "some companies having difficulty meeting financial obligations, if oil prices drop below $10 per barrel." In the analyst's opinion, if this happens, "It is likely that the solution will be another round of restructuring and industry consolidation." And an executive of a high-tech manufacturer complains that investor interest in scientific developments waxes and wanes. To ensure financing when needed, this official recommends the maintenance of an intensive investor-relations program. Another corporate officer, the CFO of a service company deplores an unresolved worry: "Bonding, a critical component of surety in the construction industry, is becoming a scarce commodity. A new financing mechanism must be found to replace reinsurance companies."

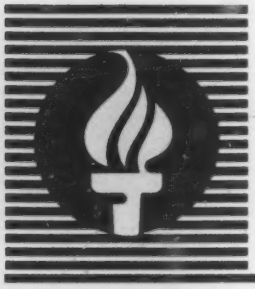
Lessening Dependence on Outside Funding

Fifty-five of the U.S. participants are attempting to reduce reliance on external financings in order to achieve their capital structure goals. Because, regardless of the form it takes, outside financing is usually expensive, these companies believe that getting existing resources to perform more efficiently will make the attainment of their objectives less costly.

As Table 23 suggests, many will employ a combination of approaches to limit their use of capital markets. Cost-reduction programs and moves to improve the management of working capital are expected to be in the vanguard of the effort. Training seminars designed to motivate managers to become less externally reliant and other measures designed to improve performance are also expected to contribute.

The emphasis adopted will vary somewhat from industry to industry. Utilities (Group C), for example, striving to lower dependence on outside funding, will zero in on tightening control over costs. Larger manufacturers (Group B), on the other hand, will stress improved cash, receivables, payables, and inventory management.

R4105-29.86 F 89



The Conference Board

The Value-Added Tax: Policy Issues for Business

Industry leaders and government officials comment on:

- *restructuring the U.S. tax code*
- *the revenue potential of VATs*
- *alternate routes to deficit reduction*
- *the impact of VATs on U.S. competitiveness*

Research Bulletin No. 236

© 1989 The Conference Board, Inc.

THE CONFERENCE BOARD, INC.
845 Third Avenue, New York, N.Y. 10022
THE CONFERENCE BOARD OF CANADA
255 Smyth Road, Ottawa, Ontario, K1H-8M7, Canada
THE CONFERENCE BOARD, INC.
Avenue Louise, 207 Bte 5, B-1050 Brussels, Belgium
THE CONFERENCE BOARD, INC.
1755 Massachusetts Avenue, N.W., Suite 312, Washington, D.C. 20036

The Value-Added Tax: Policy Issues for Business

by Jessica A. Skelly

Highlights

Action on record federal budget deficits, along with concerns about bolstering the national savings rate, is pressing Congress to reexamine U.S. fiscal policy. Key to any discussion on the federal budget deficit is consideration of the impact different revenue options will have on the economy. The value-added tax (VAT), a consumption tax used in Europe, Japan, and most developed countries, is part of this examination.

This study explores the nature and mechanics of the value-added tax, and focuses upon the key public policy issues in the debate on VATs. Commentary from tax experts, industry leaders and goverment officials shows that:

- The business community will measure whether an American VAT can be designed to support the objectives of an improved fiscal policy, while minimizing the adverse effects on the economy.
- Questions on whether the tax code could be used to reduce the deficit in the short-term, and restructured to better support private saving and investment in the long-term, will steer the debate on VATs.
- Consideration for a value-added tax must be part of a credible budget deficit plan requiring serious consideration of controlling the growth of government spending.
- The efficiency and effectiveness of implementing a consumption-based tax will be weighed against such matters as the scope and authority of the federal government, especially as it concerns the states' tax base —long considered their private fiscal preserve.

The inherent complexity of a VAT will require policymakers to assess the broad policy implications of adopting a consumption-based tax. Essential to the public dialogue on the merits and drawbacks of a VAT is consideration of the following:

- The national savings problem will be invoked by VAT advocates maintaining the need to restructure the tax code to better support private savings and investment, thereby removing the existing incentives to consume. However, the impact on saving and investment will depend on the form of the tax a VAT replaces or whether it is used as an additional tax.
- The growth of the federal bureacracy as a result of adopting a value-added tax is seen as a critical drawback. Tax opponents point to the "money machine" argument, citing Congress' current spending record. To many, adopting a VAT would allow the federal government to meet deficit reduction targets at a higher level of government spending. Whether a VAT itself triggers an increase in the rate of growth of the public sector is debated by tax experts.
- The VAT requires a substantial administrative apparatus. Also, the costs of compliance by business will vary depending on the size of industry. The experience of European countries with VAT, and their treatment of industries by type and size, is useful to the American dialogue on VATs.
- The net effect of VATs on the U.S. trade balance and the impact on the volume of exports is difficult to assess. Many tax experts believe U.S. companies would support a VAT if it was used to replace the corporate income tax.
- The regressive nature of VAT means that a disproportionate burden is placed upon the poor. Criticisms about regressivity have in the past proved politically damaging. While the structure of a VAT allows for a significant range of flexibility, thus providing policy options for addressing the fairness issue, the consequences of such action have important implications for preserving the VAT's neutrality.

The Value-Added Tax

The need to reduce the U.S. deficit is fueling renewed interest in alternative revenue-raising mechanisms, such as the value-added tax (VAT), a broad-based consumption tax. The nation's fiscal policy, affecting the spending, saving, and investment decisions of individuals and corporations, is being reexamined in an environment of budgetary pressures. While it is unlikely that a value-added tax will be considered by Congress this year, a new frontier in fiscal policy may be nearing as consensus builds to bolster the national savings rate. One of the leading tax analysts interviewed says, "The newness of a VAT in the United States and its inherent complexity should encourage business to take an active role in the policy debate, helping to inform Congress on the impact any VAT might have on particular industries or sectors of the U.S. economy."

Advocates maintain that a VAT's strongest asset is its huge revenue potential. The VAT became a major revenue source in the European Community during the 1960s and 1970s. Member countries believed a VAT was the best way to promote neutrality and uniformity of taxes, and to provide incentives for increased productivity. It was intended originally as a substitute tax for other taxes, but it has since become associated with an increase in taxation. In general, the European experience is relevant to the discussion in the United States in the following areas: efficiency as a tax system, price increases, expansion of government, and federal and state coordination and harmonization.

President George Bush and groups such as the U.S. Chamber of Commerce advocate a "flexible freeze" as a method for cutting the federal deficit: if the economy grows at a 3 to 4 percent rate per year, and if fiscal spending is reduced, there will be enough money both to reduce the budget and to implement new spending programs. To satisfy the budget agreement's call for $5.3 billion in taxes, the Administration is proposing the restoration of a capital gains tax differential.

The flexible freeze scenario also projects interest rates of 5.5 percent; the Congressional Budget Office assumes 7.1 percent. Critics say the flexible freeze makes little allowance for new spending. Moreover, according to Congressional Budget Office forecasts, in order to reduce the deficit through spending cuts alone, federal spending would have to be cut, in real terms, by 1.5 to 2 percent across the board. Spending cuts of this magnitude are considered certain to be rejected by Congress.

President George Bush and several members of Congress have proposed the restoration of the capital gains tax—establishing a maximum capital gains tax rate of 15 percent. The Tax Reform Act of 1986 eliminated the differential taxation of capital gains, thereby raising the cost of capital. Supporters of the Administration's proposal argue that lower capital costs promote higher investment and, thus, a higher standard of living.

However, the prospects for changes in the capital gains tax are not certain given the concerns over meeting deficit reduction targets and raising the revenue required under the budget agreement. The Treasury Department estimates that President Bush's proposed capital gains tax break would raise $4.8 billion in fiscal year 1990, $4.9 billion in fiscal year 1991, and $3.5 billion in fiscal year 1992. But the Joint Committee on Taxation (JCT) staff disputes Treasury Department revenue estimates of the proposal, saying that it would lose $24.2 billion over six years.[1] The main point of contention is whether, in the years immediately following 1989, the capital gains tax break would increase the deficit.

The Treasury Department has attempted to reconcile its old estimates with the JCT's estimates by arguing that much of the revenue gain from the repeal of the tax break shown in the earlier estimates resulted from a lowering of tax rates rather than the capital gains proposal itself. "Who's right? That's the first thing we'll have to determine when the Finance Committee takes this matter up," commented Senator Lloyd Benston, the Texas Democrat. Dan Rostenkowski, Democratic Chairman of the House Ways and Means Committee, recently reversed his opposition to the capital gains cut, acknowledging that the reduction might be the only negotiable proposal. Whether the Democrats accept the President's proposal for a 15 percent cut, and whether a consensus is reached on the consequences of the tax cut for both the economy and meeting deficit targets, is yet to be decided.

The pressure on lawmakers to meet the $5.3 billion target required under the budgetary agreement may convince Democrats to consider the capital gains proposal. Supporters of the capital gains tax differential maintain that it has important and beneficial economic consequences that should be considered separately from the ongoing debate over the revenue implications. Primarily, the restoration of a capital gains differential will have significance for the U.S. saving rate, the cost of capital, entrepreneurial initiatives, and international competitiveness. Of the latter, supporters say that the cost of capital in the U.S. is considerably higher than in Japan, West Germany, and most other foreign competitors. Senator Alan Cranston, a California Democrat, commented: "The issue of capital gains is not a Republican vs. Democratic issue, and it's not a rich vs. poor issue. The issue is what is best for the health of our economy; what will give taxpayers an incentive to save more and to invest more in long-term, risky projects? The answer, in my opinion, is a lower capital gains tax."

Many economists and financial leaders believe that reducing the national deficit will require an economic austerity package that goes beyond the Administration's proposals. A credible budget deficit-reduction plan, they say, would require

[1] Memorandum from the Joint Committee on Taxation Chief of Staff Ronald Pearlman to House Ways and Means and Senate Finance Committee Chairmen, Providing Revenue Estimates of President Bush's Capital Gains Tax Cut Proposal. February 23, 1989. Taxation, Budget and Accounting. Bureau of National Affairs, Washington, D.C.

a serious examination of current tax laws and their effects on private savings and investment. The Congressional Budget Office (CBO) estimated that revenues will have to increase to at least $100 billion if the annual deficit —$155 billion in 1988—when adjusted for the cost of Social Security and Medicare, is to be reduced to $50 billion. The CBO projects a budget deficit of $148 billion for fiscal year 1989. (See Table 1 for CBO Projections.) When the Social Security Trust Fund surplus is excluded from CBO estimates, the projected deficit actually rises from $199 billion in fiscal year 1989 to $220 billion by 1993. Critics of the Administration's plans say that relying upon the Social Security Trust Fund surplus in setting deficit targets undermines serious efforts to build the political consensus needed to make difficult budget choices.

If reducing the federal budget deficit becomes a fiscal priority, Congressional action is likely to involve a shift in spending priorities and a reorientation of the tax code to promote private saving and investment. It is estimated that a VAT will provide between $13 and $22 billion dollars annually per percentage point levied (based on projected 1989 data). A broad-base VAT, equal to about 2.3 trillion, would probably apply to about 70 percent of total personal consumption, say some tax experts. Thus, to raise a $100 million of revenue would require a tax of at least five to eight percent. The revenue base would grow as the economy expands.

The viable revenue options are limited. As shown in Table 1, none of the proposed options produces the needed revenue. Two of the revenue alternatives being forwarded are:

- Raising personal income tax collections by broadening the base or by a rate increase, or
- Introducing a revenue source such as a national retail sales tax or a national value-added tax.

Other revenue options, including taxes on imported oil, on all oil, on energy, gasoline, cigarette and alcohol consumption, or increases in excise taxes and tariffs simply will not generate the money required to ease the budget deficit, say some experts. The federal taxes on beer, wine and spirits have been raised only once since 1951. The gasoline tax is the only federal excise tax that has increased at a rate equal to inflation. If increased, the federal excise tax on motor fuels (now at 9.1 cents a gallon on gasoline and 15.1 cents per gallon on diesel fuel) would yield $1 billion in extra revenue for each penny raise —that is, until the increase in price became a deterrent to driving.

Indeed, propopents of a gasoline tax say it would raise substantial revenue without the costly administrative apparatus required to implement a value-added tax. Congressional bill HR 1023 calls for a phased-in 50-cent-a-gallon increase in the federal gasoline tax. Despite the fact that U.S. taxes on motor fuels are among the lowest in the world, such a tax increase may not win Congressional approval. The revenue from such taxes is usually earmarked for infrastructure development and repairs, and their regressive nature could prove too powerful a deterrent. (see Table 2, p. 6.)

Table 1: Projected Budget Deficit
($ Billions)

	Projected Deficit		Deficit Target
	CBO (1)	OMB (2)	
1989	$148	123	$135
1990	136	102	100
1991	131	85	64
1992	126	65	38
1993	121	34	0

Source: (1) Congressional Budget Office, August 15, 1988
(2) Office of Management and Budget, July 29, 1988

Views from the Business Community

Given a range of options, chief executives of 120 U.S. companies, firms with at least $1 billion in revenues, recommended a VAT over any other tax option, according to a recent study conducted by Northwestern University. Martin Zimmerman, chief economist for Ford Motor Co., explained in an interview that spending reductions are the preferred way to reduce the deficit. "But if this proves politically impossible," he says, "a tax increase that does not have an adverse effect on private saving, investment, and economic efficiency should be pursued." Moreover, a July 1989 Conference Board survey of 400 CEOs (The Federal Budget Deficit) shows 42 percent in favor of VAT, 35 percent opposed.

This is not to say that the business community as a whole supports a VAT or any general tax increase. "A consensus on the means to reduce the deficit will not be reached by corporate America", according to Michael Monroney, former vice president for governmental relations at TRW, Inc. As chairman of the newly formed Coalition for Fiscal Restraint (COFIRE), Monroney represents seventy-nine trade groups, corporate members and citizens groups that have come together to ward off a tax increase. "Increasing taxes only results in more spending, leaving the federal deficit at a still higher level. The Gramm-Rudman-Hollings legislation does not limit government spending to any specific dollar amount. It is structured so that if income goes up, the targets for reducing the deficit will rise accordingly," states Monroney. In short, any move to increase taxes will be strongly resisted if the tax is believed to contribute to higher government spending rather than a lower budget deficit.

Table 2: Other Revenue Options

	OPTION	FIVE-YEAR REVENUES ($ Billions)	CUMULATIVE ($ Billions)
1.	Tax Inside Buildup on New Life Insurance Policies	2.0	2.0
2.	Increase Taxes on Distilled Spirits	2.0	4.0
3.	Phase Out Mortage Interest Deductions for Second Homes	2.3	6.3
4.	Eliminate all Private-Purpose Tax-Exempt Bonds	3.3	9.6
5.	Index Current Cigarette and Alchohol Tax Rates	5.9	15.5
6.	Extend OASDI Coverage to New State and Local Government Employees[1]	8.2	23.7
7.	Extend HI Coverage to State and Local Government Employees Not Now Covered[2]	9.0	32.7
8.	Limit Mortgage Interest Deductions to $12,000 per Return (Single) or $20,000 (Joint)	10.3	43.0
9.	Increase Top Marginal Rate of Corporations to 35 Percent	13.3	56.3
10.	Raise Cigarette Tax to 32 Cents per Pack	14.9	71.2
11.	Disallow Deductions for Half of Business Meal and Entertainment Expenses	18.4	89.6
12.	Raise Taxes on Beer and Wine to Rate on Distilled Spirits	20.7	110.3
13.	Prohibit Deductibility of State and Local Taxes Above Ceiling of 7.5 percent of AGI[3]	21.2	131.5
14.	Raise AMT Rate for Coporations to 25 Percent[4]	23.7	155.2
15.	Add a 33 Percent Bracket for Individuals	29.6	184.8
16.	Delay Indexing of Income Tax Schedules Until 1990	31.0	215.8
17.	Raise Marginal Tax Rates for Individuals to 16 Percent and 30 Percent	147.4	363.2
18.	Five Percent VAT, with Exemptions for Food, Housing, and Medical Care	264.5	627.7

[1] Old Age, Survivors and Disability Insurance
[2] Health Insurance, refering to Medicare hospital insurance
[3] Adjusted Gross Income
[4] Alternative Minimum Tax

NOTE: Revenue estimates based on Reducing the Deficit: Spending and Revenue Options (Congressional Budget Office, March 1988).

The Nature of the Value-Added Tax

There are three main types of VATs, each differing in their tax treatment of capital investments in plant and equipment: consumption, income, and gross product VATs. Under a consumption VAT a firm's purchases of plant and equipment are treated the same way as any other purchases, i.e., they are "expensed." The consumption VAT is used in developed countries and it is the only type of VAT that has been seriously proposed for the United States. Under the income VAT, the VAT paid on the purchases of capital inputs is amortized over the expected lives of the capital inputs, and the amount amortized is credited against the firm's VAT liability. The gross product VAT allows no deduction for the VAT on purchases of capital inputs against the firm's VAT liability.

The value-added tax is one means of collecting a general sales tax on consumer goods and services. In contrast to a retail sales tax, a VAT is a tax assessed on goods and services

as they move from producer to wholesaler to retailer, a tax levied at each stage of the production/distribution process. The value-added tax, collected piecemeal at every stage of the cycle, is ultimately passed on to the consumer since the retail price paid will reflect the entire VAT levied during the production and distribution process. Thus, each "increase in value" triggers a value-added tax (see Exhibit 1, p. 8).

Value-added can be calculated as the difference between a firm's sales revenues and the cost of its purchases from all other firms. A firm's "value-added" is, in effect, the amount of value that a firm contributes to a good or service by applying its resources of production (e.g., land, labor, capital, and entrepreneurial ability). The total national potential for VAT collection can be calculated as the VAT rate applied to total retail sales. The sum of the values added along the production process—both materials and labor—equals the product's retail price. The range of revenue that can be raised depends on differing rates throughout the cycle and the breadth of the tax base itself.

Considering the high costs of administration, introducing a VAT at a rate below 10 percent is not considered cost efficient. At a 10 percent rate, the administrative costs, as a proportion of revenue, should be about 1-2 percent. Standard rates are commonly between 15 percent and 25 percent. The direction for VAT rates has been generally upward.

VAT Tax Terms and Philosophies

Two of the most contentious issues relating to implementing VATs concern what operations should be taxed or exempt and the choice of single or multiple rates. All suppliers of goods and services are either taxable or exempt. Thus, a comprehensive consumption tax assesses tax liabilities against all incomes. A uniform tax is one that applies the same tax rate to all taxable activities. In reality, few VAT taxes are either comprehensive or uniform. Political pressures would incline the United States towards a VAT with various exemptions and different rates.

An exempt business collects no VAT on sales and receives no credit for VAT paid on purchases from other firms. Thus the exempt business has to pay VAT on purchases without being able to claim this purchase tax liability on sales. Exemption status does not provide complete relief from the impact of VAT; for example, if farmers are exempt from VAT they need not register with the tax authorities. Nonetheless, they pay VAT on all their inputs —fertilizer, seeds, and electricity—and on capital purchases, including farm buildings and machinery. The farm is thus out of the VAT system and is treated as a final purchaser; it is not registered with the federal government and therefore has no compliance costs. Exemptions are designed to improve the progressivity of the VAT.

A zero-rated business, such as a book store in the United Kingdom, collects no VAT on sales but receives credit for VAT paid on purchases from other firms. A zero-rated firm is registered and therefore creates compliance costs. This method applies a tax rate of zero on the sale of a good or service and allows a full deduction for VAT paid on purchases related to the sale of a product. Zero-rating is the only way to ensure that goods are provided free of VAT and thus used for the benefit of the final consumer. Justification for using zero-rating is given on two grounds: goods and services are considered "meritorious," and thus deserve to be tax free. Secondly, the administrative burden is such that some goods and services are too difficult to tax.

Economists agree that the zero-rating of many goods and services would change the relative prices of products and, in effect, distort consumer choices. Governments tend to prefer exemption over zero-rating because of the saving in administrative costs and the higher revenue yield from the former form of VAT. "An important impetus for a U.S. VAT is the concern that reliance on the income tax creates a bias against saving in favor of consumption. A consumption-type tax removes this bias, leaving the choice between saving and investment, and consumption, neutral," maintains Charls Walker, chairman of the Council on Capital Formation and a former Deputy Secretary of the Treasury.

Many financial experts believe that a broad VAT base is necessary if the VAT is to remain a neutral tax. A broad-based tax makes no distinctions between stages of production. For example, it is possible to implement a manufacturing-stage VAT or a VAT through the wholesale stage, but not including the retail stage. In practice, these sorts of distinctions often involve complex rules about minimum markups or maximum retail percentages creating more distortions than they solve, experts note. Taxing all stages in the production/distribution process eliminates the need for price adjustments. Moreover, if many products are zero-rated or exempt the tax is likely to need to be higher in order to meet desired revenue goals, economists point out.

Calculating a VAT

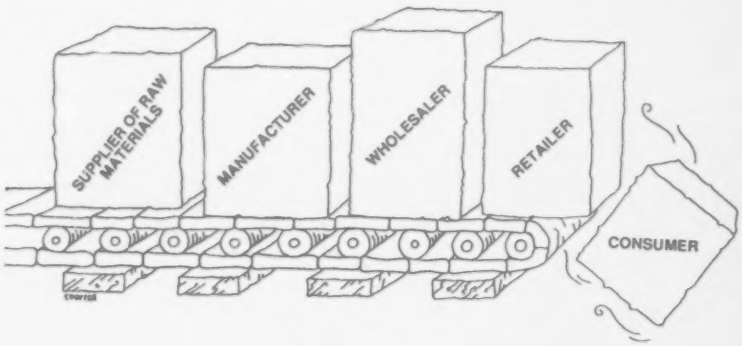
VAT tax liabilities can be calculated by three techniques: the addition, subtraction, and the invoice or credit method. The addition method is used for implementing an income-based VAT and, thus, would not be suitable if a consumption-based VAT becomes the focus for U.S. policymakers. Under the addition method the statutory tax rate is applied directly to value added; this method recognizes that under the income concept value-added equals the sum of factor payments and profits. All components of income must be defined to calculate the base.

The subtraction method does away with the need for a complex adminstrative apparatus, involving only a few additional lines to the existing federal business tax return. The VAT base is then simply the difference between the total sales and total purchases from other firms. This information is taken from books of account rather than from sales invoices.

The invoice/credit method attaches tax liability to the transaction, therefore making it, its proponents claim, legally and technically superior to the other procedures. Although the subtraction method forces adoption of a single rate with no exemptions, and can be put into place quickly, most experts doubt that such a VAT would be politically acceptable to Congress.

Exhibit 1

How a VAT Works



Supplier of Raw Materials	Manufacturer	Wholesaler	Retailer	Consumer
Sells to manufacturer for $100	Sells to wholesaler for $500	Sells to Retailer for $1,000	Sells to Consumer for $2,000	
Collects 10% VAT: $10	Collects 10% VAT: $50	Collects 10% VAT: $100	Collects 10% VAT: $200	
	Receives Credit for VAT paid to supplier -$10	Receives Credit for VAT paid to manufacturer -$50	Receives credit for VAT paid to wholesaler -$100	
Pays to Government $10	**Pays to Government $40**	**Pays to Government $50**	**Pays to Government $100**	

Total paid to Government= $200

This example, using the invoice/credit method of calculating, involves firms at four different stages of production:
- — supplier of raw materials
- — manufacturer
- — wholesaler
- — retailer

The rate for the VAT is assumed to be 10 percent.
The example assumes that the VAT is fully shifted forward to the next stage of production. Thus, the consumer pays the entire VAT.
The four firms remit $200 in VAT. The consumer pays $200 in VAT on top of the $2,000 in retail sales.

Stage 1.
In the first stage of production it is assumed that the raw material supplier provides all inputs. The raw material supplier has sales of $100 and VAT on sales of $10 (10 percent of $100). The sales invoice shows the $10 in VAT on sales. Because the supplier originated the raw materials and did not purchase inputs, no credit for prior VAT paid is given. The raw materials supplier remits $10 to the federal government.

Stage 2.
In the second stage of production, the manufacturer has sales of $500 and VAT on sales of $50 (10 percent of $500) which is shown separately on the sales invoice to the wholesaler. The manufacturer purchased $100 in raw materials on which $10 was already paid in VAT on the purchase invoice. The manufacturer credits the $10 paid on VAT against the $50 of VAT collected on sales, and remits the difference of $40 to the federal government.

Stage 3.
In the third stage of production, the wholesaler has sales of $1,000.00 and VAT on sales of $100 (10 percent of 1,000). The wholesaler purchased inputs for $500 and paid an additional $50 in VAT. Therefore, the wholesaler credits $50 in VAT paid on inputs against the $100 paid in VAT sales and remits $50 in VAT to the federal government.

Stage 4.
In the final stage of the transactions, the retailer has sales of $2,000 and owes a gross VAT of $200 (10 percent of 2,000). The retailer purchased $1,000 in inputs and paid an additional $100 in VAT. The retailer credits the $100 in VAT already paid on inputs against the $200 in VAT due on sales, and remits the difference—$100.00—to the federal government.

Pros and Cons

All three methods reflect the value added to the product as it moves through the various stages of the production/distribution process and all three methods yield the same tax liability. However, neither the addition nor subtraction method can readily accommodate multiple rates and exemptions, and tax is lost on exported goods that are then reimported as finished products.

Walker maintains that the expected two-year time lag for starting up a VAT under the invoice/credit method is eliminated if a subtraction method is adopted. The Japanese, who are planning to establish a single-rate VAT, intend to use the subtraction method. Both the addition and the subtraction methods are generally viewed as a tax on business. (see Table 3.)

However, there is no consenus on the preferred method of collection. Dr. Emil Sunley, Director of Tax Analysis for Deloitte Haskins & Sells and former Treasury department official, commented:

> "It is true that the subtraction method forces adoption of a single rate but then the argument is raised, is it necessary to have a single rate? Also, the petroleum companies, for example, believe the subtraction method would make it more difficult to pass the tax forward. Although there is little difference in the incidence of the invoice/credit VAT and the subtraction method, most economists are likely to prefer the invoice/credit."

The latter method is the technique used by the U.S.'s major trading partners, the European Community, Canada, and some Latin America countries. The invoice/credit, although more complicated, has important design advantages that deal with issues of narrow-focus exemptions and progressivity. Under the addition and subtraction methods, if a sale is exempt at one stage of the production/distribution chain, the tax is never made up. However, if an exemption is made lower in the chain on the invoice/credit method, yielding to a VAT charged to the next company in the chain, the government still obtains the full amount of the VAT.

The significant advantage of the invoice/credit technique is that it leaves a trail of information that facilitates compliance and enforcement, thereby making tax evasion more difficult. Voluntary compliance is real since a firm will need to show its customers the amount of VAT they are charged. The audit trail, with an invoice for each transaction, works to ensure that inputs are deducted only when tax is paid and when inputs exceed taxable sales. The invoice/credit method, applied throughout the production process, works to facilitate government collections since companies find it more convenient to calculate their tax liability using an up-to-date assessment.

Calculating the Tax Liability

To determine a firm's net VAT liability, using the invoice/credit method, a firm first determines its gross tax liability by multiplying its sales by the VAT rate. Then, the net

Table 3: Three Methods of Calculating VAT Liability

(10% Value-Added Tax)

	Company A Manufacturer	*Company B Retailer*
Addition Method		
Wages	$150	$300
Rent	50	100
Interest	25	75
Profit	25	25
Total	250	500
Value-added tax	$ 25	$ 50
Subtraction Method		
Sales	$350	$850
Purchases	(100)	(350)
Value-added (sales minus purchases)	250	500
Value-added tax	$ 25	$ 50
Credit Method		
Sales	$350	$850
Tax on Sales	35	85
Purchases	100	350
Tax on purchases	(10)	(35)
Value-added tax (tax on sales less tax on purchases)	$ 25	$ 50

Source: Prepared by Touche Ross and Co., adapted from U.S. Teasury Department, "Tax Reform for Fairness, Simplicity, and Economic Growth" (Washington, D.C.: USTD, November 1984), 3:9.

VAT liability is determined by subtracting VAT paid on purchases from other sources from the firm's gross VAT liability. Although business may view value added as sales-less-purchases, the base should also be reflected in the payments for labor and capital that enhance value. Under the invoice/credit method, a company incurs a VAT liability on the full amount of its sales but receives credit against that liability for the VAT it has paid on goods or services acquired to become part of its operations.

How Does a VAT Treat Capital Costs?

Under the U.S. tax system, capital costs are recovered by amortizing them over the asset's economic life. A similar approach is proposed for determining the VAT base on such assets, the amount on which the tax rate is applied. A VAT is paid on the value of the capital assets when purchased, but it is recovered only over time. Another approach is one that recognizes that resources are "consumed" in the process of acquiring capital equipment. According to Irwin David of Touche Ross & Co.:

> "The entire VAT paid on the acquisition of a capital item should be fully recoverable in the current year. Basically, this

reduces the overall VAT proceeds for the current year since the VAT on the sales resulting from the use of capital equipment will be spread over many years."[2]

In this approach, all capital purchases would be offset at once, making profits much smaller in the early years of capital purchases. The profits shown in the income tax system (i.e., in the "profit and loss accounts") would differ greatly from those calculated for VAT.

In comparing the two approaches to capital cost recovery, the consumption (current expenses) approach is simpler to compute than the income (depreciation) approach. The consumption approach ignores whether an item is a capital cost or an operating expense as well as what should be appropriate useful lives. On the other hand, a depreciation approach is reminiscent of an income-based tax: a VAT is imposed on capital equipment when purchased (by denying a deduction) and also on the output of that equipment when it is sold. Those countries with a VAT, using the consumption-type approach to capital cost recovery, allow an immediate deduction for the costs of adding capital equipment. Because the VAT base shrinks under the consumption approach, a higher rate may be sought to produce the desired revenues, according to Touche Ross & Co. analysts.

[2] Irwin T. David. *Emerging National Financial Issues. Potential Impact of a National Sales Tax on State Governments.* Paper presented at the National Association of State Auditors, Comptrollers and Treasurers. Touche Ross and Co., Washington, D.C. November 15, 1989.

Implementation Issues

Economic Efficiency

A history of proven administrative feasibility, good compliance, reasonable administrative costs, and public preference are cited as important reasons for considering a value-added tax. A VAT would be a revenue alternative consistent with tax systems used by our international trading partners. Forty-five countries now have a VAT; Japan's 3 percent consumption tax became effective April 1, 1989. A recent public opinion survey found the U.S. public prefers a consumption tax to an increase in individual income taxes by a two-to-one margin.[3] It is used at the national level in 19 of the 24 members of the Organization of Economic Cooperation and Development (OECD). Public costs associated with broad-based consumption taxes have been reasonable in developed nations and the United States. In the United States, administrative cost for state sales taxes averages 0.73 percent of revenue.[4]

In contrast to an income tax, a VAT does not tax income from savings. The U.S. income tax is said to discriminate in favor of current consumption because it taxes the return to saving —first when income is earned by an individual or business and again when savings produce a return. That significantly influences decisions about such matters as debt vs. equity financing.[5]

A VAT is considered efficient if all goods and services are taxed neutrally, at the same rate, so that consumer choice is not distorted. The requirements of neutrality place pressures on policymakers to avoid using exemptions and differential rates.

In Europe, the nature of preexisting tax systems makes it difficult to observe a VAT's efficiency of resource allocation. Any assessment of efficiency must make a distinction between those countries where VAT was designed to increase revenues and those in which it was to act solely as a replacement tax. Most member states of the EC introduced a VAT as an equal yield revenue source, that is, a tax which would produce the same amount of revenue as the tax it replaced (see Table 4.) Countries that use VAT not only to replace existing sales taxes, such as Denmark and New Zealand, are most relevant to an American dialogue.

Preceding VATs in Europe was the "cascade tax," whose defects persuaded the French, first, to institute a VAT using the invoice/credit method. The European cascade tax exacted a straightforward percentage of all business transactions. Because the tax was levied on the receipts of a firm, with no allowances made for taxes already paid on purchases of other capital goods or other business purchases, it became know as a cascade tax. The defects of the cascade tax are well documented; it is estimated that the effective rate of a cascade tax of 4 percent is equivalent to a retail sales tax of 10 percent.

The introduction of the VAT in the early 1960s, with a tax on net accretions of value, was welcomed as a finer management tool than the burdensome cascade tax; the credits have the effect of rebating the taxes paid earlier in the production process. In Germany and the Netherlands —where the VAT replaced what was judged to be a defective cascade tax—the gains in efficiency were high. In Denmark and Norway, where the VAT replaced a wholesale and a retail sales tax, the gains were said to be relatively modest.

The European experience has led some to believe that the introduction of a flat rate VAT in the United States, with an equal reduction in the personal income tax, would improve the efficiency of the economy. Indeed, one study concludes that a flat rate VAT, a differentiated VAT, and a progressive

[3] Advisory Commission on Intergovernmental Relations. *Changing Public Attitudes on Government and Taxes.* Washington, D.C. 1986, p. 41.
[4] John F. Due, and John L. Mikesell. *Sales Taxation: State and Local Structure and Administration.* Baltimore, Johns Hopkins University Press, 1986.
[5] Charles E. McLure, Jr. *The Value-Added Tax, Key to Deficit Reduction?* American Enterprise Institute for Public Policy Research, Washington, D.C. 1987, p. 30.

Table 4: Examples of Effects on Prices of Introduction of VAT in Europe

	Date VAT Introduced	Taxes Mainly Replaced[1]	Designed Effect on Revenue	Immediate Price Change		Other Concurrent Tax Changes	Any Other Concurrent Changes	Price Controls
				General[2] (In percent)	Attributed to VAT[3] (In percent)			
Austria	Jan. 1973	Cascade wholesale tax	Equal yield	2.4	Nil	Lower income taxes	Strict credit control	Yes
Belgium	Jan. 1971	Cascade wholesale tax	Equal yield	2.6	Nil		Increased wages	Yes
Denmark	July 1967	Wholesale tax	Increase	8.0	5.0	Lower income tax	Increased transfers and increased wages	No
France	Jan. 1968	Simpler VAT	Equal yield	2.1	1.0	Tax exemptions abolished and income tax adjustments	Increased wages	Yes, after VAT introduced
Germany, Fed. Rep. of	Jan. 1968	Cascade retail tax	Equal yield	1.5	0.6			Monitored
Ireland	Nov. 1972	Wholesale and retail sales tax	Equal yield	5.5	Nil	Some tariff reductions		Monitored
Italy	Jan. 1973	Central and local government sales tax	Equal yield	6.3	Nil		Increase wages	No
Luxembourg	Jan. 1970	Cascade wholesale tax	Equal yield	3.5	Nil			No
Netherlands	Jan. 1969	Cascade wholesale tax	Equal yield	5.2	1.5	Lower income tax	Increased wages	Yes
Norway	Jan. 1970	Sales taxes on 65 percent of consumption	Loss	7.8	5.8	Reduced income and property taxes	Increased transfers and wages	Yes
Portugal	Jan. 1986	Cascade sales tax and minor duties	Equal yield	10.0	(3.0)			No
Spain	Jan. 1986	Cascade sales tax	Equal yield	2.8	2.0		Major administrative changes	Monitoring
Sweden	Jan. 1969	Retail sales tax	Equal yield	1.6	Nil	1 percent payroll tax to offset lost revenue		No
United Kingdom	Apr. 1973	Multirate wholesale tax	Loss	4.9	0.7	Selective employment tax removed		Monitoring

Source: The International Monetary Fund, 1988

[1]This column is a brief summary: "cascade wholesale tax" extends the turnover tax to include the wholesale state: "cascade retail tax" extends the turnover tax to include the retail stage: "manufacturers," "wholesale," or "retail" taxes are single stage taxes—some operated on a ring system, others on a credit system.

[2]The consumer price index for the quarter before VAT is deducted from that for the quarter after VAT and the difference expressed as a percentage increase.

[3]Figures in parentheses represent broad estimates based on examination of the data: other figures are based on external and contemporary commentaries.

expenditure tax are more efficient than the pre-1986 U.S. personal income tax.[6] The flat rate VAT appears to be far more efficent than an income tax surcharge. However, European practice shows that a VAT itself cannot prevent an increased reliance on direct taxes. In Belgium and Ireland, for example, halting the rise in the direct tax burden (also referred to as "bracket creep") did not automatically occur as a result of implementing a VAT. Observers believe that determined political leadership may be the only means to resist the temptation to use VAT resources as yet another vehicle to increase expenditures and thus the tax burden.

As mentioned, a VAT's efficiency is judged, in part, by how neutral the tax remains. The basic rule is to use a single rate VAT. Both official adminstrative costs, as well as those borne by the private sector, rise dramatically as the number of rates multiply. The most simple VAT formula, (i.e., one positive rate, a zero rate, and some exemptions), requires at least nine pieces of information from each taxpayer. The New Zealand VAT is most often cited as an excellent example of a broad-base formula, one that includes food, new housing, public utilities, clothing, government purchases and sales, leasing, and some financial services. The New Zealand government was able to resist arguments for both zero rating and exemptions, and, consequently, they were able to introduce the VAT with little difficulty. By contrast, in Ireland, with two rates, 38 separate tax forms are required. Obviously, increasing the number of rates complicates a tax whose main liability is its inherent complexity. The chance for calculation errors becomes greater as does the likelihood for evasion.

To help alleviate the administrative burden, European countries do not require use of an official invoice form. In all EC Member States, the tax authorities accept most documentation that is in use commercially and that contains the appropriate information required for a VAT invoice.

Enforcement and Costs of Compliance

The transition costs generated by a federal VAT include start-up expenses. These encompass all activities that require becoming acquainted with the new tax policies and learning how to administer them. The transition requires the government to prepare new regulations, learn how to process new tax forms, and educate agents regarding changes in the tax code. Firms and individuals will also need to learn how to comply with the new tax.

A firm has a financial interest in ensuring that the amounts of VAT paid on input purchases are accurately recorded on its purchase invoices since the firm receives credits against its VAT liability. A VAT's self-enforcing procedures enhance compliance, and VAT provides the tax authorities with an opportunity to verify the amount of VAT collected. A VAT collected on the sales from the wholesaler to the retailer, for example, has traceable invoices on both the sales of the wholesaler and the purchases of the retailer. The amount of the VAT collected, reflected on the two invoices, should not change when audited.

To determine VAT compliance costs a firm needs to evaluate the size and costs of the resources committed to VAT work, including wages, salaries and fringe benefits of full and part-time staff involved with the implementation of the tax. Overhead costs of the employees must also be calculated. Some firms collect more VAT on sales than they pay on purchases. Alan Tait of the International Monetary Fund explains:

> "The cash-flow will vary according to a firm's relative sales and purchases, their commercial credit periods, and the proportion of annual VAT payments held on average throughout the year. Firms selling on credit and getting little supplier credit —often a feature of smaller firms—would not gain this advantage. The scale of advantage depends on the interest rate and the gain is not to the economy, but only represents an interest-free loan from the tax authorities."

Administrative Costs

Under a VAT with the invoice/credit method of collection, each firm would be required to keep invoices on all sales and purchases from other firms, and these invoices would be subject to audit by tax authorities. Compared to a retail sales tax, a VAT requires more information to be reported and audited, involving the entire production process, and thus a VAT could be expected to raise administrative costs for all businesses.

The Internal Revenue Service (IRS) estimates that, for fiscal year 1988, a VAT would cost the federal government $700 million to administer and require 20,000 additional employees. There is an expected two-year time lag before a VAT could go into effect, and a consumer-directed educational campaign would be required.

The administrative cost of a VAT is measured as a percentage of revenue raised. The U.S. Treasury Department estimates, using 1988 data, that a broad-based VAT would yield $24 billion for each one percent of the tax levied. Thus, the administrative costs —$700 million—would be less than one percent of the revenue from a broad-based VAT of three percent —$72 billion.[7]

However, there is some controversy over the Treasury's estimates on the staffing required and the expenses incurred in implementing a VAT. For example, Alan Tait comments:

> "The value-added tax requires a substantial [amount of] administration. The minimum number of extra employees that the Treasury calculated is a substantial underestimate. The U.S. Internal Revenue Service (IRS) audits about 2 percent of its income, estate and gift tax return and relies on witholding to collect. By contrast, countries using VAT audit 10 to 15 percent of their businesses annually, cannot use withholding for VAT, and collect a higher proportion of the VAT through the

[6] Charles L. Ballard, John Karl Scholz and John B. Shoven. "The Value-Added Tax: A General Equilibrium Look at Efficiency and Incidence," in *The Effects of Taxation on Capital Accumulation*, ed. by Martin Feldstein. University of Chicago Press, Chicago, 1987.

[7] U.S. Treasury, Office of the Secretary. *Tax Reform for Fairness, Simplicity, and Economic Growth.* Vol 3., Value-Added Tax. Washington, November 1984. p 113.)

customs import stage than would be true of the United States. Various country examples indicate that the IRS may have to budget for a substantially lower ratio of staff to taxpayers than estimated hitherto. A more traditional ratio would suggest 1:250 and a consequent fourfold increase in the number of staff needed —from 20,000 to 80,000.

"These alternative estimates imply substantially higher figures, from $410 million to something well over $1 billion. There is no point in incurring these much higher costs unless you receive a very large amount of revenue. To make it worthwhile as a percentage of tax revenue, combining a federal VAT and the state sales tax, you are talking about a 10 percent VAT or a 15 percent combined additional tax."

The IRS estimated that 20 million businesses would be required to collect the VAT and file returns. This number, based on 1984 data, does not forecast the reduction in administrative costs if small businesses were exempt. However, it is likely that small business would be granted special treatment when lawmakers consider the revenues generated from all business versus the related administrative costs. For example, 58 percent of all firms had business receipts of less than $25,000. These firms account for only about three-fourths of one percent of total business receipts. Thus, the loss of revenue would be little compared to the significant administrative costs of VAT compliance (see page 16).

VAT affects a firm's cash flow —regardless of business size. Using the invoice/credit method, the VAT would be payable on sales at the time the sales invoices are mailed and on inputs at the time invoices are received. Thus, a VAT would adversely affect the cash flow of a business that remits to the government more promptly than it collects receivables. Consequently, some businesses may have to borrow additional working capital in order to make tax payments.[8]

[8] American Bar Association. Special Committee on the Value-Added Tax. "Technical Problems in Designing a Broad-Based Value-Added Tax for the United States," *Tax Lawyer*, vol. 28, no. 2, Winter 1975.

Potential Impact of a VAT

U.S. Competitiveness and Balance of Trade

The corporate income tax places U.S. firms at a tax disadvantage in international trade, say many executives. Under the General Agreement on Tariffs and Trade (GATT), differential treatment of direct and indirect taxes is made for border tax adjustments (BTAs). These adjustments waive or rebate consumption taxes on exports while applying them to imports. All indirect taxes on export transactions (such as a VAT) may be rebated and are not treated as export subsidies, which are prohibited under GATT. The corporate income tax, unlike a VAT, is considered a direct tax and is therefore not rebated.

Developed countries using a VAT apply the "destination principle" to international trade; all present VAT systems are based on this. Accordingly, a country levies a VAT on imports but gives rebates for VAT paid on exports. Thus, imported goods tend to rise in price by the percentage of the VAT, while exported goods do not increase in price.[9] Those advocating a VAT believe that current GATT asymmetries place U.S. producers at a disadvantage both at home and abroad. Others, however, question the net effects on foreign trade and believe VAT advocates base their judgments on too narrow and partial a view of the tax change.

Many economists agree that a U.S. VAT alone cannot improve the competitive position of the United States in world markets. The export rebate merely allows exporters to enter world markets free of VAT, not at a subsidized price below the pre-tax price. If the United States were to adopt a broadly based consumption tax with the destination principle, some U.S. companies might expect to be freed from having to shoulder the U.S. tax in addition to paying foreign levies. Linking a VAT to a reduction or replacement of the corporate income tax may attenuate some business opposition.

If a VAT is introduced as an instrument for replacing the corporate income tax, goods produced in the United States and exported would have only foreign taxes with which to contend. A VAT should not significantly affect the U.S. balance of trade because any secondary price effects of a VAT on the trade figures are likely to be neutralized by adjustments in exchange rates, say some experts. Michael Schuyler of the Institute for Research on the Economics of Taxation comments,

"Discussion on whether, and to what extent, the U.S. balance of trade would be improved if a VAT with border adjustments was substituted for the existing income taxes, remains largely speculative. A value-added tax's impact on U.S. trade requires consideration of an array of complex factors including whether the VAT is a substitution for the income tax or an additional levy, the degree of specialization of U.S. exports and imports, the extent and nature of changes in the capital flows in response to the tax revision, and the change in monetary policy associated with the introduction of the tax."

Schuyler continues:

"On the whole, it is quite possible that a VAT which replaces the corporate income tax would result initially in an expansion of U.S. exports and a reduction in imports. The net effect on the balance of trade is uncertain, but it is likely that the volume of exports, and quite possibly of imports, would be greater than before the tax change. If, however, a VAT were imposed as an additional tax, exports would not be likely to increase, although imports might be depressed. In this case, any improvement in the trade balance is likely to be obtained at the cost of lower levels of output and income as a consequence of the impostion of the additional consumption tax."

[9] Congressional Research Service. *Value-Added Tax for Deficit Reduction.* October 19, 1988.

Impact on Savings

The net effect of a VAT on saving and investment depends on the form of the tax it replaces and on whether it is used as an additional tax. In addition, a VAT that is used to reduce the fiscal deficit could also be used to reduce public sector borrowing, and thus stimulate investment. Advocates contend that a VAT creates a better climate for saving; the consumption-based tax, they argue, can be structured so as to exempt the savings and investment that deficit reduction is supposed to encourage.

Though considerable effort has been made since the early 1980s to reduce deficits, with the budget deficit expected to be just above 3 percent of the GNP in 1989, the rate of private net savings has declined more rapidly than the budget deficit, causing the national net savings rate to also fall. In the 1970s, private net savings averaged 8.9 percent of GNP, while the federal deficit averaged 1.7 percent of the GNP, implying a net national saving rate of 7.2 percent, (the sum of individual and corporate saving, plus government surpluses or deficits) according to the U.S. Department of Commerce. By 1987, the national net saving rate declined 5.4 percentage points, to 1.8 percent. Two thirds of the decline is attributable to the fall in private savings while only one third was the result of an increased budget deficit.[10]

Many economists agree that eliminating the budget deficit will not eliminate the national savings problem. The challenge, therefore, is not just to cut the budget deficit but also to increase national savings, thereby reviving investment. For some, a VAT is the preferred incentive to slow the growth of consumption relative to the growth of national income.

[10] Lawrence Summers. *Financial Times.* January 3, 1989. p. 13

Policy Issues

Big Government

The VAT is often faulted as a vehicle for encouraging government to grow larger. The "money machine" argument contends that government will grow more rapidly if a new source of revenue is made available to Congress. Critics of the VAT, in order to bar further tax proposals, cite Congress' current spending record.

Alan Tait of the International Monetary Fund maintains "It is not so much that VAT triggers an increase in the rate of growth of the public sector, but rather that countries with a large government expenditure look for efficient ways to finance that government outlay and, in effect, move to implement a VAT." In fact, as Table 5 shows, although 6 of the 11 countries adopting a VAT did increase their average annual public spending as a percent of gross domestic product (GDP), the actual receipts did not grow as rapidly as outlays; the difference showed up as increases in the rate of growth of the deficits in these nations. The evidence suggests that adoption of a VAT does not automatically trigger an increase in the rate of growth of the public sector; VAT is a way to finance government spending but is not a cause of government spending. Nonetheless, the U.S. Congress may be required to adopt strict measures in order to make a value-added tax politically and economically acceptable.

VAT legislation could include a set of fiscal amendments to the Constitution for consideration by the States. These might include some version of the balanced budget amendment, which permits approval of deficits only by a vote of a "supermajority" in each House of Congress; an amendment limiting federal spending to a stated percentage of GNP; and an amendment either capping VAT at the original level or permitting an increase only on the vote of a substantial majority in each House. Without some overall constraint on government's ability to tax and spend, a VAT will face serious opposition. "Strong presidential leadership and iron-clad measures to ensure the money raised is used only for deficit reduction is the only way a VAT should be considered," argues Charls Walker.

The European experience of changing rates has only been upward, and standard rates are now between 15 percent and 25 percent. The highest standard rate of VAT in Europe, 25 percent, is levied in Ireland. Some European countries apply a reduced rate of 5 or 6 percent to food products. In the United Kingdom, food, books, and baby clothes, items considered "social goods," are zero-rated.

The current move in Europe, with the creation of the unified market in 1992, is toward tax approximation among the twelve Member States. Harmonization of value-added taxes and excise taxes are key issues on the European Commission's agenda.[11] The EC wants member countries to align their VAT tax rates since widely differing taxes distort trade. A minimum value-added tax rate of "slightly above" 14 percent, with a rate of between 4 and 9 percent on essentials like food and clothing, is recommended. The proposal would also allow the United Kingdom to keep its zero rates on books, food and children's clothes. If accepted by finance ministers, a transition phase could begin as early as the end of 1989. During this period countries would start trying to bring their rates closer together and seek ways to adjust to the lost revenue.

Regressivity

According to critics, VATs place a disproportionate burden upon poor families since they must spend a larger proportion of their income on goods and services than do the wealthy.

[11] Catherine Morrison. *1992: Leading Issues for European Companies.* Report 921. The Conference Board, 1989.

Table 5: Size of The Government Sector Before and After the Imposition of VAT

	Years	*Average Annual Growth in Outlays as a Percentage of GDP*	*Average Annual Growth in Receipts as a Percentage of GDP*	*Average Deficit or Surplus as a Percentage of GDP*
Austria	1965–72	0.29	0.40	–0.01
	1973–82	1.01	0.53	–2.50
Belgium	1965–70	0.84	0.90	–3.56
	1971–82	1.65	0.89	–5.63
Denmark	1965–66	1.80	2.30	1.56
	1967–82	1.70	1.11	–0.81
France	1965–67	0.30	–0.10	–0.30
	1968–82	0.75	0.59	–1.36
Germany, Fed Rep. of	1965–67	1.00	0.60	–1.20
	1968–82	0.74	0.54	–2.39
Ireland	1965–71	1.23	1.40	–4.53
	1972–81	1.76	0.62	–9.10
Italy	1965–72	0.61	0.11	–4.34
	1973–82	1.90	1.28	–9.78
Netherlands	1965–68	1.73	1.70	–1.58
	1969–82	1.48	0.96	–2.83
Norway	1965–69	1.42	1.63	3.36
	1970–82	0.64	0.77	3.03
Sweden	1965–68	2.23	2.00	2.95
	1969–82	1.80	0.95	–0.10
United Kingdom	1965–72	0.53	0.51	–1.35
	1973–82	0.73	0.81	–5.22
Group average	Pre-Vat	1.09	1.04	—
	Post-VAT	1.29	0.82	—

Source: Terree Alverson, "Does the Value-Added Tax Contribute to Increased Government Spending and Taxation?" *Economic Outlook*, Chamber of Commerce of the United States (Washington), April/May 1986.

Labor organizations such as the AFL-CIO would seek to block any regressive tax increase on such equity grounds. Criticism about regressivity has proven to be politically fatal in the past. Therefore, to make the VAT more equitable, and secure passage through Congress, the following policy options are likely to be considered:

- Selective exemptions of certain products, such as food or medicine. This may cause "economic distortions" by raising the prices of taxed goods relative to untaxed goods.
- Allocation of some VAT revenue for increased welfare spending. The primary disadvantage of this option is that not all poor households receive benefits from welfare programs.
- Adusting indexed transfer payments. This option does not reach all low income families and may actually benefit some in higher income classes.
- Refundable income tax credits. The drawback of this measure is that many low-income households do not file a return and, consequently, are unlikely to seek a refund.
- Taxing basic necessities at a zero or lower rate, or using multiple rates (high rates on luxury items; low rates on basic goods).
- A system of reimbursements, one that combines both target payments to low-income individuals and families and automatic indexation transfer payments. This approach almost completely relieves the burden on those in the lowest income category, but may, in fact, overcompensate some families, some experts say.

If these measures of assistance are structured into the VAT, the tax loses its neutrality, maintain the critics. Introducing compensation measures to low income individuals complicates tax administration and requires expansion of federal programs.

The Effect on Retirees

A strong case made against the VAT is that a new tax on consumption would burden retirees more than would an increase in income taxes. This position assumes that consump-

tion by the elderly is financed largely by savings from past income on which taxes have already been paid. The "double" taxation, however, would effect only a small portion of the elderly population. Based on a survey of the Social Security Administration, about 70 percent of the income that the elderly receive has not been subject to income tax (see Table 6).[12] Still, because the remaining 28 percent of income comes from assets accumulated from previously taxed income there would be some double taxation. The goal of alleviating regressivity, especially as it concerns the elderly, may be addressed by direct payments to the elderly or low-income groups.

Tax experts maintain that it is important not to consider the distributional effects of the VAT in isolation, but rather to examine whether the VAT's effects will be better or worse than than the proposed alternative measures. Despite such arguments, the regressivity of the VAT has proven to be a significant barrier to its political acceptablitity.

Price Increases

In assessing the effects of a VAT on prices and on the rate of inflation, it is necessary to distinguish whether or not the VAT is introduced as a new source of revenue or as a replacement for an existing tax. The introduction of a VAT as a new source of revenue would increase the cost of taxable goods and services since the burden of the VAT is shifted forward onto the consumer. The experience of countries with VAT shows a one-time increase in price levels.

European Experience

In Denmark, where a 10 percent VAT replaced a wholesale tax of 12.5 percent, a double yield revenue increase was expected. As a result of the VAT, the consumer price index rose by 8 percent and the wage regulation index rose by 3.1 percent. In effect, the VAT is regarded as responsible for a rise of 4.9 percent in the consumer index during the 1967 start up period.

[12] Henry Aaron. "The Political Economy of a Value-Added Tax in the United States". *Tax Notes*, Tax Analysts, March 7, 1988, p. 1113.

Table 6: The Elderly: Regressivity/Distribution of Income

Income Source	*Percent of Total Income*
Social Security and Railroad Retirement	39
Earnings	16
Government Employee Pensions	7
Private Pensions	6
Public Assistance	1
Assets	28
Other	2

Source: Survey of the Social Security Administration. Henry J. Aaron, in *Tax Notes*, Tax Analysts, March 7, 1988.

Price increases can also be linked, in part, to each country's monetary policies. In Germany, for example, where the money supply was under tight control when the VAT was introduced, prices changed little. An examination of countries adopting a VAT shows that governments acted extremely cautiously about the reaction of consumers and of voters to the effect of VAT on prices. For example, a price freeze was implemented in Belgium and the Netherlands; price and wage controls were adopted in the United Kingdom; and in Ireland, a national price commission was implemented as well as profit margin controls. It is unlikely that such austere measures would be adopted in the United States, or would be successful in restraining price inflation.

Small Business

A VAT places a burden on new and marginal enterprises, especially in the realm of administrative staffing and compliance. Small businesses would incur substantial costs in complying with a federal VAT. As noted earlier, the policy implications raise questions over whether the imposition of a VAT on small business yields enough revenue to offset administrative costs. Small businesses will be keenly interested in the potential adverse effects of a VAT on cash flow, exploring mechanisms to minimize the VAT burden —such as prompt refunds and longer retention of funds. No conclusive data are available about the effects of different VAT treatments of small business on the distribution of income.[13] Zero-rating or exemptions may be suggested, but the preference for either depends on the stage of production and the structure of the industry.

Table 7 shows some aspects of European tax treatment of small businesses.

An alternative to exemption is a "forfait" assessment on small businesses. Forfait is a tax levy based on estimated annual sales. The U.S. Treasury Department uses the number of employees to measure annual sales. Using a forfait assessment, the federal government would receive some VAT revenue but less administrative costs would be involved. Some European nations apply a forfait assessment on small business in efforts to reduce administrative costs. However, the prevailing procedure in Europe is to exempt small business from VAT.

Nonprofit Organizations

The application of a VAT to nonprofit organizations, currently exempt from sales taxes, will also need to be considered. Under the income tax, nonprofit organizations are accorded preferential treatment. Under a VAT, the questions would be raised as to whether and how such organizations should be accorded preferential treatment on purchases or receipts. Regular "commercial" activities of nonprofit organizations are likely to be subject to the regular VAT. Tax would be collected on sales, and credit would be allowed for taxes paid on purchases. The most difficult problems would involve goods and services that compete with those provided by governments

[13] John F. Due. "The Exclusion of Small Firms from Sales and Related Taxes." *Public Finance*, vol. 39, no. 2, 1984. p. 203.

Table 7: European VAT Treatment of Small Firms

Exemptions of Small Firms from Sales Taxes, Based on Annual Sales Volume

Country	*Year Instituted*	*Firms Exempt with Annual Sales of less than $U.S.*[1]	*Treatment of Exempted Firms*
Value Added Taxes:			
Belgium	1980	44,803	exempt
		44,803– 80,646	higher tax on supplier
		80,646–268,817	forfait
		498	exempt
Denmark	1975	59,453	forfait[1]
France	1980	7,312	exempt
Germany	1984	7,312– 21,938	digressive scale
Ireland	1980	2,238[2]	exempt
Italy	1980	3,557	forfait
Luxembourg	1977	1,792	exempt
Sweden	1980	1,238	exempt
United Kingdom	1980	7,003	exempt
France	1980	101	exempt
Equivalent sales figure		912	
Netherland	1980	665	exempt
Equivalent sales figure		3,697	exempt

[1] Based on 1984 exchange rates.
[2] £ 2,000 for 2 months if 90% sales exempt or 10%.
£ 1,000 2 months if rate above 10%.
£ 300 service and others.

Source: John F. Due. The Exclusion of Small Firms from Sales and Related Taxes. *Public Finance*, vol. 39, no.2, 1984.

and private firms but are provided at less than cost. Policy questions will turn on whether such goods and services should be subject to tax, whether they should be excluded from the tax base, and if so whether this should be through exemption or zero-rating procedures.

Federal/State Government Conflicts

State and local governments have long considered the sales tax as their private fiscal preserve and, consequently, will view a federal VAT as an intrusion that restricts their present and future revenue-raising capabilities. The general sales tax is one of the primary sources of revenue for many states. Any movement to adopt a VAT will confront questions of practicality: how can the federal government appropriate a general sales tax from the state's revenue base?

In a federal system, implementing a VAT requires harmonization and coordination between the state and federal taxation procedures. The ability to coordinate state and federal bureaucracies is contingent upon many factors: the type of VAT, the taxpayer base to which the tax is applied, the consistency of rates among the taxpayer base, the exemptions provided, and the product or service registration requirements.

VAT advocates may try to encourage states to abolish their retail sales taxes by, in effect, shifting them to the federal VAT. A state using a refundable tax credit would be much fairer than a state without a refundable credit, proponents maintain. States with relatively high marginal income tax rates might find it desirable to use proceeds of a state VAT to cut back those rates. A VAT's impact on states' flexibility vis-a-vis the tax base may be offset by the current move in many states away from a sales tax to taxes which are deductible for federal income tax purposes. However, in the current debate, VAT experts say, the reality is that the sales tax will continue to be a major source of income for state and local governments.

Opponents of a VAT argue that a federal consumption tax will curtail the ability of states to raise additional revenue by increasing their sales taxes. Retail sales taxes at the state level have been at relatively low rates: the median for all states for 1985 was 4.6 percent. In addition, the states' tax base is limited, with 29 states not taxing food and 25 states exempting most services. Consequently, many federal and state officials fear that the VAT would be an administrative nightmare.

According to one scenario, states would have to replace their sales taxes with a VAT of the same base as the federal VAT. In effect, states would give up some of their fiscal discretion.

Still, the level of coordination and the type of tax could adversely affect the states' control of their tax bases and the states' fiscal autonomy.

Reconciling Federal/State Conflicts: The Experience Abroad

In all countries VAT is levied as a national government tax and, consequently, federal governments have had difficulty in reconciling a new federal VAT with existing state and local sales taxes. In a federal system, difficulties arise on issues of coordination, harmonization, and an agreed-upon scope of national governmental activity. The experience in the Federal Republic of Germany, with proven feasibility of revenue sharing, may be a model for other federal countries. In Germany, the states (Länder) collect the federally legislated VAT at common rates on a common base. The administrative responsibilities of the VAT rest with the states and uniformity of application is enforced by court rulings. Total VAT revenue is split approximately 70/30 between the federal government and the states.

The VAT can work in a federal system only if the states find it in their interest to make the collection system work. In Canada, with 11 provinces, an accounts-based VAT enables provinces to levy their own varieties of rates; this style of collection may be too complex to operate in the United States. Where the states try to retain more discretion over their own exemptions, rates and revenues, such a tax system cannot work. States need to perceive that the formula for revenue distribution is fair, with an agreed and objectively measured criteria.[14]

Impact On Governmental Services

The impact of a VAT on government transactions is a serious issue since state purchases are currently exempt from the retail sales tax. Furthermore, because some sales by state organizations are subject to a sales tax and others are not, the impact of a VAT on both government sales and purchases raises fundamental questions. For example, user charges for providing a product or service, such as utilities or a city's refuse collection, will need to be reexamined. The imposition of a VAT becomes even more complicated when the government service is provided by a private contractor. This raises complex questions: should a VAT applying to purchases by governments be exempt, and if so, how is that portion of the VAT to be separated on sales by a supplier to the government? Will all levels of government be treated the same under a VAT, including, for example, government-owned corporations such as Amtrak?

States are expected to resist a federal VAT, even if offered attractive coordinating procedures for sharing the new tax base. Past experience underscores state resistance to any interference with its revenue collection. For example, the federal government's offer to collect income taxes for states was refused by all 50 states. Other concerns of state legislators are likely to include:

- Will a federal value-added tax absorb the tax-paying ability of citizens and leave less money in the system available for state governments?
- A federal taxation of the sales base impacts the states' ability to raise money. If the federal government taxes the same base as the state government, the state will have less flexibility to increase or change the tax base.
- If the bases and the rates for both federal and state are not the same, what are the compliance costs likely to be? For example, in some states, services are not subject to the state sales tax, but these would most likely be affected by a value-added tax if implemented.
- Depending on the design of the VAT, how will mechanical and coordination problems between the federal and state governments be resolved? There is no precedent for harmonization.

[14] Alan Tait. *Value-Added Tax, Internatonal Practice and Problems.* International Monetary Fund, Washington, D.C. 1988, p. 158.

R4105-29.87U 9/89

The Conference Board

U.S. Corporate Earnings Outlook

Conference Board Economic Forum predicts:

- *End to impressive profits gains of 1980s*
- *Higher production costs from slow growth and accelerating wages*
- *Wide variation by industry in profits outlook*

Research Bulletin No. 238

Participants–The Conference Board Economic Forum, June 20, 1989

Nevins Baxter
Chairman
BEI Golembe, Inc.

Adrian T. Dillon
Assistant Treasurer and Chief Economist
Eaton Corporation

Edgar R. Fiedler
Vice President and Economic Counsellor
The Conference Board, Inc.

John Gorman
Assistant Chief
National Income and Wealth Division
Bureau of Economic Analysis
U.S. Department of Commerce

George W. James
President
Airline Economics, Inc.

Edward Johnson
Director
Johnson Redbook Service Division
Prescott, Ball & Turben

Maryann Keller
Vice President
Furman Selz

Bruce Kirk
Vice President
Goldman, Sachs & Co.

J. Steven Landefeld
Special Assistant to the Chairman
Council of Economic Advisors

Mickey D. Levy
Chief Economist
First Fidelity Bancorporation

David Lothson
Senior Vice President
PaineWebber

Richard D. Rippe
Senior Vice President and Economist
Dean Witter Reynolds Inc.

Theodore Semegran
Senior Vice President
Shearson Lehman Hutton

Dillard Spriggs
President
Petroleum Analysis, Ltd.

G. Leonard Teitelbaum
First Vice President
Merril Lynch, Pierce, Fenner & Smith

© 1989 The Conference Board, Inc.

THE CONFERENCE BOARD, INC.
845 Third Avenue, New York, N.Y. 10022
THE CONFERENCE BOARD OF CANADA
255 Smyth Road, Ottawa, Ontario, K1H-8M7, Canada
THE CONFERENCE BOARD, INC.
Avenue Louise, 207 Bte 5, B-1050 Brussels, Belgium
THE CONFERENCE BOARD, INC.
1755 Massachusetts Avenue, N.W., Suite 312, Washington, D.C. 20036

Mixed Signals on Profits

Edgar R. Fiedler

The profitability of U.S. corporations reached a healthy level in 1988 and 1989. This is true despite the gradual narrowing in the profit rate of return that has occurred since World War II, mostly due to more intense competition, especially competition from abroad. In the 1980s, however, profits have behaved very well, recovering vigorously (as they normally do) through the years of business-cycle expansion.

Edgar R. Fiedler
"Profits headed down or merely leveling off?"

From here forward, however, the profits outlook is problematic. This was the conclusion of the 15 members of the Economic Forum brought together by The Conference Board to consider the outlook for corporate earnings in 1989 and 1990. Their views on the direction of profits were mixed, with the economy-wide analysts leaning toward the pessimistic side and the industry analysts providing a little more encouragement. These who regularly follow profits on an economy-wide basis believe the impressive gains of the 1980s are now behind us. The peak occurred near the end of 1988. The main reasons why profits turned down are the changes in prices and costs that usually take place late in the business cycle. First, the growth rate of the economy has slowed, which restricts productivity gains thus raising production costs. Slower growth also weakens the pricing climate. Second, the dollar has strengthened recently, which reduces import prices and curtails demand for U.S. exports, although usually with a lag. And third, wage increases have accelerated, which also raises costs. This combination of downward pressure on prices and upward pressure on costs leads, inevitably and promptly, to lower profits.

The key factor that will determine how far corporate earnings are squeezed is the strength of economic activity. Profits are highly sensitive to the business cycle. Thus a recession always knocks profits for a loop. The Forum analysts are not looking for a recession, at least not soon, but some are expecting a pronounced slowing of the expansion. This is important for profits because of its effect on the pricing environment and productivity. When operating rates are high and demand continues to grow, companies are better able to raise prices relative to costs and (as long as capacity utilization is not *too* high) to run their facilities efficiently. Accordingly, those who anticipate a slow economy are forecasting an erosion but not a collapse of profitability, with aftertax corporate earnings down some 12-15 percent, peak quarter to trough quarter, over the 2-year span to late 1990. By contrast, those who expect economic growth to continue look for profits to be well maintained at or near present levels. To sum up the economy-wide point of view, then, corporate profits appear to have relatively little potential for gains. The unresolved question within the Forum is whether profits are headed down or are merely leveling off.

A Better Industry Perspective

From an industry perspective, however, the outlook is more favorable. The squeeze on profit margins expected by the economy-wide analysts was confirmed only in the paper, chemicals, and automobile industries. All three show signs of less price firmness, limited efficiency gains, and accelerating compensation costs. Such signs were not reported, however, for the other industries represented. That is not surprising in steady-growth sectors like packaged foods and health care. But favorable profits forecasts for such often-volatile industries as airlines, petroleum, soft-goods, machinery and equipment, and financial services is encouraging. With seven of the Forum's ten industry representatives projecting improved corporate earnings for 1989 and 1990, the profits outlook might turn out to be more promising than suggested by the economy-wide analysts. Here is a brief summary of the profits outlook for the ten industries covered by Forum analysts:

Packaged Foods. An important lesson of recent decades in the food business is that the major companies, although they often cannot do it with other products, do know how to make money on food. Now that they have again narrowed their focus to food, the profits outlook is encouraging. In the period immediately ahead, these prospects are enhanced by a more accommodative commodity outlook, a slowing of the esca-

lation in advertising costs, a moderating of capital-expenditure requirements, and a broad product line that permits strong volume growth regardless of economic circumstances. Consequently, over the next 12-18 months earnings growth is expected to be at a rate of 12-14 percent per year.

Retail, Apparel, and Textiles. In 1987, sharply escalating prices for women's wear coupled with the fashion confusion created by the short skirt sent the soft-goods industries into a minirecession. In the fall of 1988, however, women got tired of what was in their closets and wanted something new, which triggered a rebound in sales and profits. Earnings in retail trade are expected to rise 8 percent in 1989 and 5 percent in 1990. Textile company profits will be up 10 percent this year and 5 percent in 1990. For apparel companies the earnings gains will be 20 percent this year and 10 percent next year.

Forest Products. Profits momentum in the paper and forest products industry began to weaken in mid-1988. On a year-to-year basis, earnings will be higher for 1989, but on a quarterly basis the peak is passing. The key factor behind this development is the decline in capacity utilization, currently around 95 percent, down from 96 percent in 1988. As a result, prices have softened—newsprint is down 10 percent, for example—and productivity gains have slowed. Costs continue to rise, including labor costs, which are up 2½ to 3 percent this year, compared to 2 percent in 1988. Thus profit margins are narrowing. Earnings per share advanced 66 percent last year and 15-20 percent in the first quarter of 1989 (over the first quarter of 1988). The second quarter forecast is for a 9 percent increase, followed by gains of 0-5 percent in the second half and, on average, a decline of 5-10 percent in 1990.

Chemicals. The favorable upswing of profits in the chemicals industry is coming to an end sooner than expected. The pricing environment has softened, while costs continue to creep up. How the economy behaves is crucial. If operating rates sag across the board, earnings will drop sharply. But that seems likely only for a few products. Nevertheless, unless export demand stays strong, the profits outlook is only so-so.

Petroleum. The oil industry is currently reaping the best of both worlds in two ways. OPEC is overproducing at a good price, and refinery operations are experiencing high margins right alongside the high price for crude. Profits are thus at record levels. Next year, the profits picture will be a lot bumpier, especially on the producing side, as an easing of demand growth coupled with overproduction is likely to be reflected in volatility in crude prices. The overall tilt should remain positive, however, because refinery profits are likely to remain strong, and the same is probably true for natural gas, now that the supply surplus has dwindled and prices are strengthening.

Automobiles. Over the past half-dozen years, the U.S. automobile industry has experienced a benign economic and regulatory environment, and profits have increased to record levels. The honeymoon is over, however. The second quarter will mark the end of favorable comparisons, as slower sales and higher costs depress profits, a trend that is likely to continue through 1990. In 1989, industry profits will decline to $9.2 billion from approximately $11 billion in 1988, and the tentative outlook for 1990 is another drop to about $8 billion. As we look further ahead, the Japanese appear to be a greater threat to the automobile industry for the 1990s than they were in the 1980s.

Machinery and Equipment. In the 1980s the profitability of capital-goods companies was squeezed badly, first by the deep recession and then by severe international competition arising from the strong dollar. Interestingly, the deterioration was most prominent in the rapidly growing information-processing sector. Only in 1987 and 1988 did industry profits begin to return to a respectable level. With continued growth expected in the economy and especially the capital-goods sector, the 25 percent advance in 1988 profits should be followed by further increases of 15 percent or so in both 1989 and 1990.

Airlines. The industry has done better in recent years. Deregulation has been digested and the structure of the industry has consolidated into an oligopoly. As a result, profits have begun to recover. The secret was strong demand and smarter pricing. The companies succeeded in switching more business travelers out of discount seats into full-fare seats, roughly tripling the yield on each switch. Short term, the profits outlook continues to be very optimistic.

Health Care. The industry is growing powerfully and steadily, unaffected by the business cycle. Costs are rising at a pace that gives nightmares to anyone uninsured and will probably lead to nationalization by the mid-1990s. In the shorter run, the private sector of this industry will see earnings compound in the mid-teens this year and next.

Banks and Thrifts. Despite the alarming headlines, the outlook is favorable. At commercial banks profits will be up 8 to 10 percent both this year and next, while at thrift institutions, assuming interest rates drop another percentage point or so, earnings will be up 7-8 percent this year and 15 percent or more in 1990. A safer and more important conclusion about the 1989-90 outlook is that there will continue to be widely different results among companies and regions. In Texas, all the major banks have been or are in the process of being recapitalized and are back on their feet financially. In the rest of the country, another Texas does not seem likely.

Some Historical Perspective on Profit Rates of Return*

John Gorman

The Commerce Department publishes a series on the profitability of nonfinancial corporations, specifically on the rates of return on reproducible physical assets owned by those companies. These statistics cover more than 40 years, a period with quite variegated economic conditions. The data are available on both a current replacement cost basis (as shown in the accompanying chart) and in an approximation to historical cost. The differences between the two arise from the way the historic cost numbers are warped when the rate of inflation changes.

John Gorman

"The long decline is due to stiffer competition."

The history of profitability over the past 40 years can be summarized in four propositions:

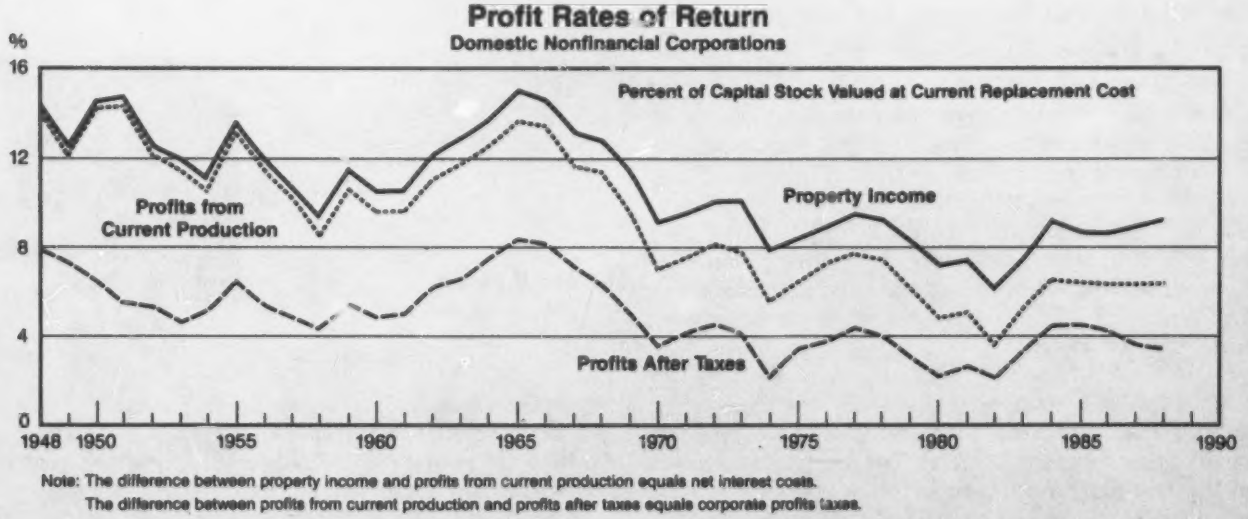
- The rates of return move up and down in close correspondence with the business cycle.
- The average level of the property income rate of return—the total return to equity and debt—has been much lower in the 1970s and 1980s than in the 1950s and 1960s.
- In the 1970s and 1980s a much smaller share of total property income went to the government in profits taxes and a much larger share to interest recipients than in the 1950s and 1960s.
- The rate of return realized by shareholders is lower, even in good years,during the 1980s than it was during recession years in the 1950s and 1960s.

What explains the weakness in the profit rate of return in recent years, and particularly the decline in the stockholder's share? One possibility is that the decline in profitability is fictitious, merely a statistical apparition arising from the unreliability of the data. An alternative explanation is that the weakness in profit rates of return is a consequence of the heavy environmental investments required in recent decades. Still other possibilities are increased competition or incompetent corporate management.

Reliability of the Rate of Return Data

In my view the statistics on the rate of return are quite dependable. Through 1985, property income, the numerator of the ratio, is based essentially upon tax-return information. These data are less than perfect, but actually are of high quality. We monitor the Internal Revenue Services's statistical opera-

* The opinions expressed in this document are those of Mr. Gorman and not necessarily those of the Bureau of Economic Analysis or of the U.S. Department of Commerce.



Note: The difference between property income and profits from current production equals net interest costs.
The difference between profits from current production and profits after taxes equals corporate profits taxes.

tion, and it is good. For example, they make a comprehensive accounting of all corporations that in the preceding year had total assets of $10 million or more. If there is no return in the current year, its absence has to be accounted for in terms of the merged successor or spun-off companies. Thus we get a good tracking of tax returns as filed. There is, of course, misreporting. We estimate misreporting, and find that it has been rising as a share of property income in recent years. Thus our misreporting adjustment tends to increase property income relatively more in recent years, a direction contrary to that observed in the rate of return.

The net stock of capital valued at current replacement cost, the denominator of the ratio, is calculated from investment estimates by a perpetual inventory method. Since they are synthetic estimates dependent upon judgments about service lives and discard functions, the capital stock estimates might be subject to drifting away from their true level over time. We have a check, however—comparison of the historical cost gross capital stock estimates from the perpetual inventory with the gross depreciable assets from the balance sheets filed by corporations with their tax returns. This check indicates that over the period from 1959 to 1981—a period bridging both the eras of high and low rates of return—the perpetual inventory method largely paralleled the balance-sheet data. Thus there is no evidence of drift and, indeed, there is reason to trust both components of the rate-of-return ratio.

Alternative Explanations

What about the environmental explanation? Well, it is certainly true that much more capital has been devoted to pollution abatement during the period since 1970 than before. Such capital lowers the rate of return by adding to the capital stock while adding nothing to profits. I would put very little stress on this explanation, however, because pollution abatement capital accounts for only 2 to 3 percent of the total capital stock, which would move the rate of return calculation only a tiny fraction of the decline that took place from the mid-1960s to the late 1980s.

What about increased competition and managerial incompetence? Neither is subject to statistical proof. Although it is possible that the competence of U.S. corporate executives has deteriorated over the decades, my guess is that it has either improved or changed very little. A more fruitful hypothesis, it seems to me, is a resurgence of competition. Over the years domestic U.S. markets were opened up to more and more foreign participation. At the same time, the transportation and communication industries were substantially deregulated. These and other changes have made it harder for corporations to carry out oligopolistic pricing strategies effectively. Thus although it cannot be proved, I lean toward growth in competition as the prime explanation for the long decline in shareholder earnings as a percent of investment.

Outlook for Corporate Profits, 1989-1990

Richard D. Rippe

Increases in corporate profits have accompanied the business expansion and have played a major role in the advance of stock prices over the past seven years. But at the present time the outlook for earnings is a restrained one due to:

- Slower volume growth;
- Reduced pretax profit margins that reflect a mixture of slower volume growth, prospective reduction in operating rates, the higher value of the dollar, faster wage increases, and slower productivity growth;
- Stable tax rates for 1989 and 1990, but at levels above those that prevailed prior to the 1986 Tax Reform Act; and
- Profits from operations that lag reported earnings because higher inflation has brought renewed sizable inventory profits and less generous depreciation allowances provided under the 1986 tax bill.

It is helpful to split aggregate profits into three components: nonfinancial corporations (domestic results), financial corporations, and overseas earnings. The forces affecting each of them are somewhat different.

The domestic operations of U.S. nonfinancial corporations is where the bulk of total profits are generated. As the economy decelerates, so will volume at nonfinancial corporations. Dean Witter expects real gross domestic product to rise by 2.5 percent in 1989 and 1.2 percent in 1990, after gains of 4.3 percent in 1987 and 5.3 percent in 1988. Slower output growth provides less opportunity for earnings gains.

Richard D. Rippe
"Declining profitability ahead."

The other consideration is what is in store for profit margins at nonfinancial corporations. We have developed a simple statistical model that explains most of the movement of pretax margains. In the period ahead, margins are likely to be affected by the following factors:

- The rate of real volume growth affects margin in the short run because, even with the most sophisticated forecasting, there is always an element of surprise: Surges in output raise profits because companies adjust expenses more slowly. With sluggish growth in prospect, though, this factor should be a mild negative.
- Capacity utilization rates serve as indicators of domestic competitive pressures; when the operating rate is high, companies have more flexibility to raise prices relative to costs and generally can run their facilities in an efficient manner. We expect a gentle declining trend of operating rates ahead, which will apply downward pressure to margins. A related consideration is that with wages rising and poor productivity, a squeeze on margins is likely.
- The real value of the dollar affects the ability of U.S. producers to compete in world markets. When the dollar fell from its highs in early 1985, margins rebounded as companies were able to gain market share and were provided some relief from import price pressures. The recent strengthening of the dollar works in the opposite direction, causing weaker volume and greater price competition from abroad. We see margins eroding due to this factor as well.

When the slower growth and weaker margins are combined, our forecast looks for a modest rise in pretax profits for nonfinancial corporations in 1989, in the 4-5 percent range, but a drop in 1990 of 5-6 percent.

As tabulated in the National Income Accounts the financial sector is a hodge-podge of industries including the Federal Reserve System along with private pension plans; the remainder of the sector includes banks, securities firms, insurance companies, real estate firms and thrift institutions. Lower interest rates will gradually help push earnings upward in this segment, but there will be uneven performance from industry to industry.

Overseas profits will be influenced by a combination of foreign economic growth and the level of the dollar, which affects translation of earnings in foreign currency into U.S. dollars. Strong growth abroad will help 1989 earnings, but the higher dollar will offset some of the gain. By 1990 growth overseas is likely to decelerate.

The most important recent developments in corporate taxation were spawned by the Tax Reform Act of 1986. There were many changes including lower marginal rates, but offsetting them are the elimination of certain credits (such as the investment tax credit), more restrictive accounting rules, and a stiff new minimum tax rate. The result has been to push the average tax rate higher, although there have been some fluctuations from year to year as the effective dates of various provisions have been different. With most of those changes now fully in place, we anticipate that the tax rate for nonfinancial corporations and for all corporations to be roughly the same as it was in 1988.

In light of these different considerations our forecast of after-tax profits shows an increase of 4 to 6 percent in 1989 and a decline of 3 to 5 percent in 1990; measured from quarterly peak to trough, the drop will be much sharper. This prospect is a sharp shift from the sizable advances that occurred in 1987 and 1988. If the economy falls into outright recession, of course, the prospects for profits would be even weaker than these estimates; even in a mild recession, a drop of 10-15 percent in the annual averages would be probable.

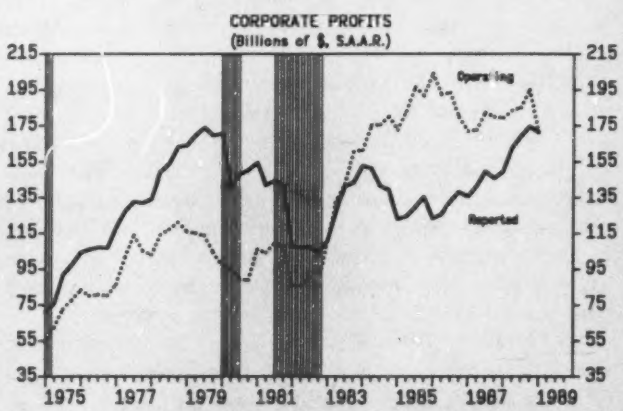
Operating Profits

A conceptually better measure of corporate results is operating profits, which start with the tax-basis data and include corrections to place inventory and depreciation accounting onto a replacement cost basis. These adjustments—the so-called IVA and CCA (inventory valuation adjustment and capital consumption adjustment)—remove profits that come from carrying inventories when prices are rising and augment (or deduct from) the stated results when tax-basis depreciation exceeds (or falls short of) the current cost of the assets wearing out. Consequently, the resulting measure shows the profits that come from current operations after the proper charges for inventories and depreciation have been taken.

Operating profits scored a sharp surge in the early 1980's, much stronger than reported profits, as may be seen in the accompanying chart. In addition to the gains in reported profits during the recovery from the last recession, there were two additional fundamental factors at work:

- Slower inflation, which reduced inventory profits and also reduced the rate at which capital goods prices were rising; and
- The liberalization of depreciation allowances under the 1981 tax bill that permitted much shorter asset lives under the Accelerated Cost Recovery System.

Not only was there a strong absolute gain in operating profits, but they surged past the reported profits; in other words the true earnings of U.S. corporations exceeded what was being reported on their tax returns by a sizeable amount.

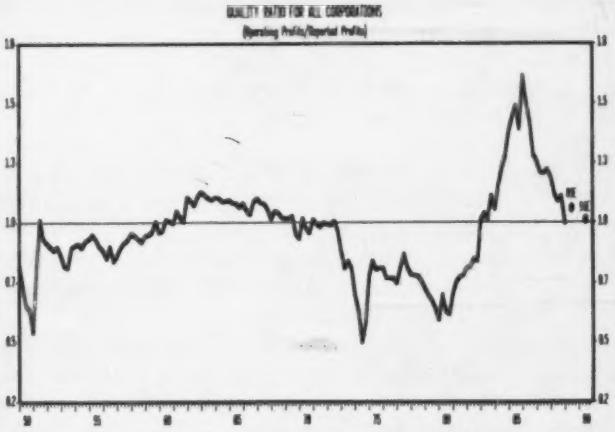


Unfortunately, in the past three years, the excess has diminished and, in the most recent quarter, was completely wiped out. Once again two principal factors have caused the operating results to return to the level of reported earnings: 1) somewhat higher inflation has boosted inventory profits, and 2) the 1986 tax bill removed much of the favorable depreciation treatment.

What is the outlook for IVA and CCA in 1989? We expect inventory profits to be fairly high this year reflecting general inflation but, more specifically, the boosts to energy and food prices that have been unfolding. Still, we expect these pressures to diminish beginning in the second half of 1989 and through 1990, so we look for the annual IVA to show some improvement next year. For the CCA, however, the trend is adverse as more and more capital equipment is placed in service on the asset lives required under the Tax Reform Act. When combined, these accounting corrections are becoming less and less of a positive factor in the profits picture. The outlook for operating profits, then, is for further declines: -5 to -6 percent in 1989 and -6 to -7 percent in 1990.

In addition to being a conceptually superior measure of profits, we emphasize the operating basis for another practical reason: Over the past 15-20 years its movements have been more closely correlated with stock prices than have most other earnings measures—including the reported tax-basis profits and the S&P 500 measure of book earnings. There are several different ways to see this association.

- A simple regression of the stock price on operating earnings reveals a higher correlation than do similar regressions on the other earnings measures.



- If one examines the performance of stock prices and operating profits over postwar business cycles, there is a general tendency for stocks to peak before the economy and for operating profits to peak before stocks.
- In a more sophisticated mode, however, the operating profits may be indirectly affecting stock prices via the price-earnings ratio.

Recently, the downward pressure on price-earnings ratios from declining quality (see accompanying chart) has been offset by lower interest rates that have emerged in response to decelerating economic growth. Still, it is not good news to have quality diminish in this fashion.

Fundamentals Generate Weak Corporate Profits Outlook

Mickey D. Levy

Corporate earnings declined sharply in first quarter 1989, abruptly reversing their 1987-1988 upward trend. On an annualized basis, pre-tax profits with inventory valuation adjustment (IVA) declined 20 percent, compared to increases of 14 percent from 1987 IV to 1988 IV and 8 percent from 1986 IV to 1987 IV. Both after-tax profits and operating profits, which correct after-tax profits for inventory inflation and capital consumption allowance adjustments, declined even more dramatically (45 percent and 48 percent, annualized). Declines in profits without IVA were significantly smaller, as a large jump in inventories and higher inflation in the first quarter substantially raised the IVA contribution to profits.

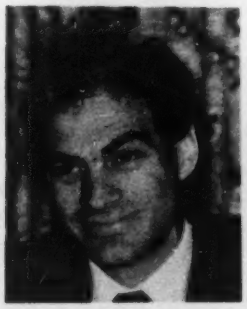
First quarter 1989 profits reports were disappointing not only because of the depth of their declines across a wide range of industries (see table), but also because the factors that contributed significantly to the rapid earnings trends in 1987-1988 now point toward further declines in profits. Both pre-tax and operating profits are forecast to decline through year-end 1990.

Factors that Affect Corporate Profits

Research indicates that trends in corporate profits are a function of four key variables: growth in product demand or production, profit margins, the U.S. dollar exchange rate, and interest rates. These variables, which interact to determine profit patterns, in turn are largely influenced by domestic and international macroeconomic policies.

Historically, profits have been most sensitive to production growth and profit margins. Cyclical movements in production may be expressed in terms of real GNP or capacity utiliza-

tion, which reflects businesses' interpretations of production and excess capacity in manufacturing. Corporate profit margins, which follow a generally procyclical pattern, measure the extent to which businesses are able to pass through oper-



Mickey D. Levy
"Profits are most sensitive to product growth and margins."

ating costs into product prices. A good proxy for changes in margins is the relationship between increases in the personal consumption deflator minus increases in unit labor costs (compensation increases minus productivity gains).

Profit margins tend to widen sharply at the initial stages of economic expansions, as unit labor costs increase more slowly than product prices. During this cyclical stage, wage growth moderates because of the labor market slack left over from the previous recession, while strong gains in productivity, generated by rising capacity utilization, suppress costs per unit. As economic expansions mature, unit labor costs tend to accelerate, as wages are bid up with tighter labor markets, while productivity improvement wanes with shrinking excess capacity and large increases in employment.

Profit margins tend to narrow as business expansions draw to a close and during recessions, as unit labor cost increases continue to rise, while decelerating product demand growth inhibits the ability of businesses to raise product prices as fast as increases in operating costs.

Interest rates affect corporate profits through their impacts on costs and levels of production, investment and financing decisions, and trends in product demand. A common perception is that interest rates now have a sizable inverse relation with profits, reflecting the persistent sharp increases in corporate indebtedness. My research indicates that controlling for trends in real GNP, for profit margins, and for the U.S. dollar, the independent impact of interest rate fluctuations on total corporate profits is minor. However, interest rates do have a significant independent effect on profits in finance industries (finance, insurance, and real estate).

Since the early 1970s, wide fluctuations in exchange rates and the significant internationalization of the goods and capital markets have made corporate profits very sensitive to changes in the U.S. dollar. Currency fluctuations directly affect the dollar value of earnings repatriated from foreign affiliates of U.S. multinational firms. Changes in the U.S. dollar also affect domestic demand growth and the costs of U.S. goods and services relative to foreign products. In general, U.S. imports are positively related to the dollar and U.S. exports are negatively related.

Pretax Corporate Profits with Inventory Valuation Adjustment
(by Industry)

	1986IV-1987IV %Chg.	1987IV-1988IV % Chg.	1988IV-1989I % Chg., annual rate
Pre-tax Profits	8	14	- 20
Manufacturing	16	18	- 25
Durable goods	- 15	41	- 38
Primary metals	N/A	104	- 53
Fabricated metal products	37	2	35
Machinery except electric	- 15	35	191
Electric & electronic equip.	N/A	N/A	-239
Motor vehicles & equipment	-48	69	- 95
Other	-10	- 2	0
Nondurable goods	36	9	- 19
Food & kindred products	24	19	52
Chemicals & allied products	34	63	- 54
Petroleum & coal products	169	- 4	- 73
Other	2	-24	16
Service-producing	- 3	15	- 18
Transportation & public utilities	- 6	18	- 9
Wholesale & retail trade	1	- 4	- 44
Other services	13	87	3
Financial	0	10	- 6
Rest of World	29	2	- 16

Recent Profit Trends

The strong gains in corporate profits in 1987-1988 were generated by accelerating product demand, widening profit margins through mid-1988, and sharp declines in the U.S. dollar in 1987. Although interest rates rose, their impact on profits was outweighed by the favorable economic environment.

The acceleration of product demand in 1987-1988 was driven by booming exports in lagged response to the earlier sharp declines in the U.S. dollar, and the pickup in domestic growth was a consequence of the very stimulative monetary policy from mid-1984 to year-end 1986. Real GNP growth averaged 4.0 percent from 1986 IV to 1988 IV, compared to 2.8 percent from 1984 IV to 1986 IV. Besides generating strong corporate revenue growth, the acceleration of product demand created an environment in which businesses were able to widen their profit margins.

Profit margins widened in 1987 and the first half of 1988 because increases in product prices outpaced increases in unit labor costs. Healthy productivity gains, primarily in manufacturing, offset a portion of the rise in wages, which limited the acceleration in unit labor costs. The widening margins began to fade in mid-1988, as increases in business operating costs began to outpace product price increases. Unit labor costs accelerated because strong labor demand pushed up wage compensation increases and productivity gains subsided, while

higher interest rates added to operating costs. As product demand growth began to slow, businesses found it more difficult to raise product prices as fast as operating costs increased.

The significant decline in the U.S. dollar in 1987 contributed significantly to corporate profitability in several ways. It stimulated demand for U.S. products, from both foreign and domestic buyers, and provided domestic firms the flexibility to raise product prices. Also, the lower U.S. dollar increased substantially the value of repatriated earnings from foreign affiliates of U.S. firms. The modest rise in the U.S. dollar in 1988 halted this trend.

During 1987-1988, higher interest rates increased corporate operating costs and cut into corporate profits. However, their impact was overwhelmed by strong product demand, rising profit margins, and the low U.S. dollar.

A wide variety of industries enjoyed strong profits in 1987-1988, with the manufacturing sector registering the largest gains. From 1987 IV to 1988 IV, profits rose 18.1 percent in all manufacturing industries, following a 16 percent gain a year earlier. Product demand accelerated more sharply in manufacturing than in the service-producing industries, reflecting the boom in exports and the general slowdown of domestic consumption relative to GNP. At the same time, profit margins in manufacturing widened significantly, while those in many service-producing industries narrowed.

There are two primary reasons for this difference. First, wages grew more rapidly in the service-producing sectors than in the manufacturing, reflecting among other factors tighter labor markets and lack of international competition. Second, productivity grew rapidly in manufacturing firms, but declined in service-producing industries. Thus, unit labor costs remained virtually flat in manufacturing, and the accelerating prices of finished goods generated sharply rising profit margins. In contrast, unit labor costs in the service-producing industries rose 6.9 percent from 1988 I to 1989 I. At the same time, slower consumption growth—consumption has been declining as a share of GNP since mid-1986—and stiff competition have inhibited price increases, squeezing profit margins in most service-producing industries.

Deteriorating Outlook for Corporate Profits

The trend of declining profits that began in first quarter 1989 should continue through year-end 1990, based on the anticipated pattern of the key variables that affect profits. Product demand growth is slowing sharply. Export growth should continue to moderate in response to the rising dollar, accelerating prices of U.S. exported goods, and efforts by foreign central banks to slow foreign economies. Domestic demand growth should also weaken in response to the Federal Reserve's very tight monetary policy. Consequently, nominal GNP is forecast to grow at a 6.3 percent annual rate (drought adjusted) from fourth quarter 1988 to fourth quarter 1989, and 4.9 percent in 1990, compared to 8.3 percent and 7.2 percent in 1987 and 1988. Real GNP is forecast to grow at a 1 percent annual rate through year-end 1990.

Profit margins, which began to narrow in mid-1988, should be squeezed further. Research shows that unit labor costs continue to rise for approximately one year following a deceleration of nominal GNP growth, reflecting both momentum in wage increases and declining productivity. At the same time, the slowdown in product demand makes it increasingly difficult for businesses to raise product prices.

The strong dollar, which cut sharply into profits in 1989 I, should continue to sap strength from profits of foreign affiliates. Interest rates are forecast to decline sharply, which will reduce business operating costs, but the slight boost they will provide to profits will be more than offset by the weak economic environment.

Consequently, pre-tax profits are forecast to decline 5.7 percent from 1988 IV to 1989 IV, and another 1 percent from 1989 IV to 1990 IV. Moreover, the quality of corporate profits will continue to deteriorate: operating profits are forecast to decline 16 percent from 1988 IV to 1989 IV and to decline 4.0 percent from 1989 IV to 1990 IV. Inventory valuation adjustments to after-tax profits have peaked and should start contributing positively to operating profits, as inventory building slows and inflation recedes in 1990. However, the negative impact of the capital consumption adjustment to profits, reflecting the less generous tax depreciation policies, will contribute to weaker corporate earnings and cash flow through year-end 1990.

Inflation and the International Outlook for Profits

J. Steven Landefeld

After declining for most of the postwar period, pretax profits and rates of return have begun to turn up. All of the major industrialized nations recorded a decline in rates of return that began in the 1960s and accelerated in the 1970s. Now in the 1980s we have seen a recovery in these rates of return for the seven largest (G-7) nations. This recovery has been most pronounced for manufacturing industries.

J. Steven Landefeld
"Most important, keep inflation low."

Given the importance of rates of return to capital formation, productivity, and real standards of living, it is critical that this recovery in rates of return continue.

A review of postwar trends in rates of return suggests that one of the most important factors in their recovery and that of capital productivity was the reduction in worldwide rates of inflation. Other factors clearly played a role, but for the most part these are not subject to policy control.

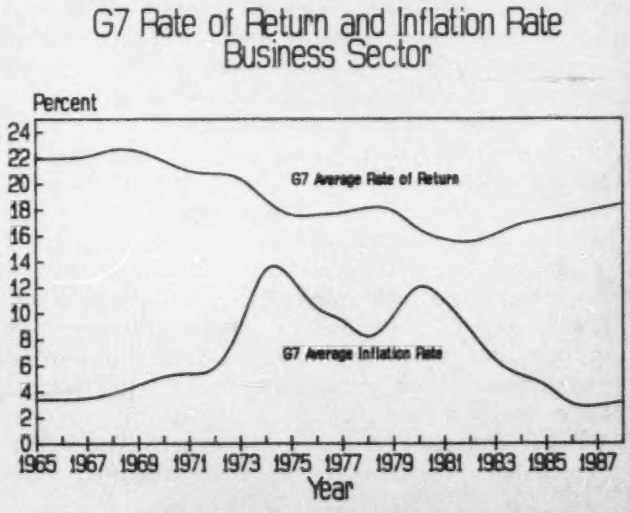
Part of the decline in rates of return and productivity growth in the postwar period was due to the depletion of the backlog of advanced U.S. technology, which other major industrialized nations, especially Japan, were able to exploit as they rebuilt their capital stocks following World War II. Another part was probably due to a secular increase in world competition that reduced market power for domestic producers in the G-7 nations. Part may have also been the result of the secular increase in social security and other nonwage labor costs. Increased competition and depressed demand in the 1970s may have combined with an inability to reduce wages and salaries by the full amount of the increase in nonwage labor costs, which contributed to the squeeze on profits and rates of return. Other factors that have been cited include increased regulation, the energy crisis, and changes in research and development funding. However, it is difficult to find strong evidence that those other factors had a significant lasting impact on rates of return.

As the chart strongly suggests, the most important factor explaining the recovery in real rates of return and capital productivity in the 1980s in the G-7 countries, except perhaps Japan, was probably the reduction in inflation. Lower inflation in the major industrialized nations had several effects on efficiency and rates of return.

It reduced the variability of relative prices, allowing decisionmakers to more accurately anticipate future relative prices, thereby allowing them to allocate resources more efficiently, especially those involving fixed dollar commitments for the future. In the United States, the variance in relative prices for non-energy goods, as measured by the producer price index, dropped 39 percent between 1973-1981 and 1981-1987.

This drop in price variability was important. For many goods, adjusting prices is costly, and as a result of these "menu" cost changes, sellers tend to adjust prices infrequently. During periods of high and variable inflation, relative prices may be more a function of past patterns than of current and future resource costs.

As inflation fell and relative prices more accurately reflected future resource costs, investment decisionmaking was improved. Costly investments in machinery and equipment, which in the 1970s were made inefficient by subsequent and unexpected changes in relative prices, were avoided. The reduction in volatility lengthened the expected useful lives of assets and enhanced decisionmakers' incentives to concentrate on long-run investment planning rather than short-run strategies.



In addition, the reduction in inflation expectations lowered nominal interest, which also lengthened investment horizons.

High and variable inflation imposes costs beyond those associated with rigidities. Sellers must bear the costs of frequent menu changes, while buyers and managers bear the cost of learning new information and integrating it into decision-making.

Lower inflation in conjunction with reduced regulation also gave managers the incentive to concentrate on basic management decisions rather than on purchasing and paperwork responsibilities. High inflation in the 1970s and early 1980s caused an increasing share of reported profits to be accounted for by "paper" profits. Reported rates of return trended upward slightly, while operating profits adjusted for inflation trended down.

During this period, inventory profits accounted for a rising share of profits. Use of historical cost accounting also understated the costs of replacing assets and the value of firms assets. The effect was to overstate rates of return. As a result, operating decisions had a smaller effect on reported profits and rates of return than inflation.

The reduction in inflation in the 1980s sharply reduced inventory profits but only slowly brought asset values and depreciation in line with replacement cost, through new investments and through the depreciation and scrapping of the old capital stock. Nonetheless, by 1987 real operating profits accounted for 64 percent of accounting rates of return, and the inflation share fell to 36 percent, versus 46 percent and 54 percent, respectively, in the early 1980s. Further progress in holding down inflation will allow accounting rates of return to even more accurately reflect the effects of management decisions. In the 1960s operating profits from current production accounted for up to 82 percent of accounting rates of return.

The single most important course governments can take to raise real rates of return and capital productivity is to keep inflation low. Contrary to the general perception that easy money and inflation help business, for most major industrialized nations during the postwar period the net effect of inflation has been to lower rates of return and capital productivity.

Central bankers need not bear all the burden of keeping inflation low while maintaining economic growth. Especially in the United States, continued progress in reducing the federal budget deficit will give the Federal Reserve "elbow" room to ease without fear of causing an acceleration of inflation.

Packaged Food Industry Outlook

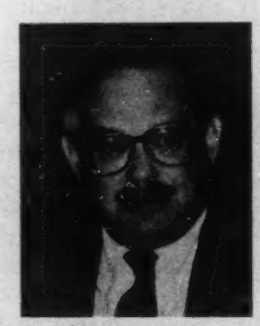
G. Leonard Teitelbaum

The outlook for profits in the food business is encouraging. The drought of 1988 will have a lingering effect on profits as the higher incurred cost of inventory moves through the income statements. Prices for packaged-food products were raised during the summer of 1988 and, in most cases, have protected rather than increased margins. For the remainder of 1989, wheat costs will continue to be a problem and packaging and transportation costs are a concern as well. Another round of price increases in the 4-7 percent area should be anticipated, but probably on a selective basis.

The sheer size of recent takeovers has engendered the theory that food prices will have to soar if margins on large segments of the branded-food market are to withstand the pressure of greatly increased interest costs. That may appear to make sense at the outset of a financial transaction, but it may prove invalid if assets are sold, which should be expected in the not-too-distant future, and debt is reduced. What should be in the forefront of every analyst's mind is the true competitive nature of the industry and, by and large, its highly competent and knowledgeable management teams. In short, this industry knows how to make money.

The metamorphosis from pure food companies in the 1960s to sprawling diversified consumer-foods companies in the 1970s and back to food companies in the 1980s has shown the flexibility of managements and their desire to manage what they know best: food and food marketing.

Historically, packaged food companies have been able to achieve annual earnings grown of 11-13 percent after-tax, and the possibility of companies achieving a 12-14 percent after-tax growth rate can be seen with some clarity. Advertising and promotion costs, which can average 18-22 percent of sales for a food company, have recently growth at a 15 percent rate and will most likely increase at a more modest rate in the future.



G. Leonard Teitelbaum
"This industry knows how to make money."

Commodities prices, which escalated almost 50 percent from July 1988 to June 1989, should be more accommodative.

Because most food companies have sufficient capacity, capital expenditure (with a few notable exceptions) will be for internal developments associated with profitability rather than for brick and mortar. In fact, several food companies have been rationalizing assets over the past few years because of the significant increase in productivity during the last five years.

Historically, food companies have maintained strong AA balance sheets and, even with stock repurchases and acquisitions, are still able to maintain high investment-grade creditworthiness. The lack of cyclicality and a high degree of consistency of cash flow should continue to be a trademark of the food industry.

Europe 1992 will begin in a small way for the food companies by the end of 1990, when certain trade barriers will be relaxed. There is and should continue to be a flurry of activity as brands in Europe test their portability. With the exception of CPC, Heinz, and Kellogg, packaged-food companies derive the majority of their business from the U.S. market.

Changing American taste preferences and demands for different yet healthful products—whether they contain oats, can be microwaved, or are cholesterol free—create opportunities for new products and increased profits both domestically and internationally, regardless of economic outlook. Cash flows, which have always been strong, should continue to show exemplary growth. The breadth of product line should result in overall unit growth, regardless of economic circumstance.

A concluding point to solidify the near-term outlook is the availability of brand names that are in some fashion available for purchase. That does not necessarily mean the headline-grabbing acquisitions or divestitures mentioned earlier. In many cases, buying a brand is cheaper than making a brand, and there continues to be a plethora of regional products that could be easily expanded by the national marketing networks of many food companies. Such brands do not always sell at extreme premiums, and financial flexibility exists for either stock or cash purchases. To date, most of that activity has escaped the major financial press and has occurred with a fair degree of regularity. Such acquisitions have added to the growth rates of several companies almost immediately.

In summary, my forecast for the packaged-food industry calls for 12-14 percent earnings growth for the next 12-18 months, based on the following expectations:

- A more accommodative commodity outlook as the country recovers from the 1988 drought.
- Food companies by and large running a business they know well.
- A moderation in the rapid escalation of advertising and promotion costs.
- Moderate capital-expenditure requirements.
- Strong balance sheets and cash flows that permit financial flexibility for both domestic and international acquisitions.
- A broad product line that permits strong growth of unit volume regardless of economic circumstances.

A Roller-Coaster Ride for the Retail, Apparel and Textile Industries

Edward Johnson

To anticipate the future, it is useful to take a brief look at the recent past. The profits picture for the soft goods pipeline industries has been on a roller coaster ride since the spring of 1987, when retail, apparel, and textile companies went into a minirecession while the economy in general continued to prosper. The earnings of these companies all suffered in varying degree with firms tied into women's apparel suffering the most.

Increases in spending (in constant dollars) on women's and girl's apparel dropped from a vigorous 8.4 percent year-to-year gain in 1986 to just 0.7 percent in 1987 and 0.4 percent in 1988, the smallest increase since 1970. Stores had been planning for a boom year similar to 1986, when unit women's wear spending was up 8.5 percent, and had inventoried accordingly. The inevitable happened: The high retail inventories backed up to the apparel and textile companies and the profits of all three industries toppled in the Fall of 1987 and continued to fall through the third quarter of 1988. At that point a rebound started and has continued to date (a period when the year-to-year comparisons were easy).

An examination of why the soft goods recession came about helps to predict the future. Women started pulling back their spending in the spring of 1987 when prices for women's wear escalated sharply. This slower spending pattern was made worse by the fashion confusion created by the short skirt and competition from high spending on autos. It became fashionable for women to sit on their spending hands and dress out of their overloaded closets. As if a whistle blew, this female attitude changed in the fall of 1988. Women got tired of what was in their closets and wanted something new. Inventories

in the soft goods pipeline had been cleaned out, so the earnings of retail, apparel, and textile companies started to climb and have been improving ever since.

Currently, the roller-coaster comparison is still applicable. *Redbook* estimates that for the first five months of 1988 sales of department stores and chains were up a strong 9.5 percent over the depressed 3 percent increase of a year ago. However, future year-to-year comparisons will be more difficult, as the earlier buying surge by women is running out of steam. There has already been a slowdown in spending on consumer big-ticket hard goods. Thus we at Prescott, Ball & Turben project that general merchandise sales will slow to a 4-5 percent increase for the fourth quarter of this year and increase 5-6 percent for all of 1990.

As for earnings projections, we do not look for a repeat of the 1987-88 inventory recession since the stores have been more careful in their buying, and both retail and soft goods producers are operating on lower inventories.

We look for pretax earnings in retail trade (as measured by the Department of Commerce) to be up 8 percent in 1989 and 5 percent in 1990, compared to a drop of 7.5 percent for 1987 and a decline of 8.5 percent for 1988. We expect earnings of textile companies to be up 10 percent for 1989 and 5 percent for 1990, compared to 0.9 percent for 1987 and a 23 percent drop for 1988. Aftertax earnings of the *Redbook* apparel companies are expected to be up 20 percent for 1989 and 10 percent for 1990. As usual the exceptionally managed companies like Walmart, May, Nordstrom, Dillards, Liz Claiborne, and Gitano are expected to outperform the group, with the poorly managed and overleveraged companies expected to have declines in earnings.

Edward Johnson
"Women are no longer sitting on their spending hands."

Paper and Forest Product Profit Outlook, 1989-1990

Bruce Kirk

The profit momentum of the paper and forest product industry is now weakening and profits are expected to decline in 1990. Supply-demand fundamentals began to signal this deterioration after mid-1988. Trade weakness is also evident. Industry common stock performance has been below that of the general market over the past year. Relative common stock valuations are very near the lows recorded before the 1975 and the 1982 recessions. The so-called soft-landing forecasts for 1989-1990 economic activity may only produce a "soft recovery" in 1991 and beyond. Industry profits will erode under such conditions. For industry common stock performance the larger risk may be time and, to a lesser extent, price.

Bruce Kirk
"Industry profit momentum is now weakening"

Industry capacity will increase, on average, 3.4 percent annually over the 1989-1991 period. With Canada included, North American capacity will rise about 4 percent, on average, and much of this new volume is targeted at the United States. Average industry growth matches that of real GNP, over time, at 2.5 percent and, thus, operating rates will decline 1 percentage point annually over the 1989-1991 period. Current evidence points to a greater operating rate decline this year, which may be due to cautious business inventory policies or relatively weak domestic final sales. The normal ratio of paper-paperboard consumption to real GNP averages 20,750 tons of consumption per billion dollars of real GNP. Through April 1989 this ratio was at 20,300 tons or 2 percent below the average.

The overall result of weakening consumption is declining industry operating rates. For 1989 to date operating rates are at 94.9 percent and will remain at this or slightly lower rates for the year. These operating rates are down from 97 percent in the 1988 period and from the 96 percent average for the 1988 year. Supply-demand fundamentals suggest that average

1990-1991 operating rates will be 94 percent and 93 percent, respectively.

For specific grades the overall picture is similar. Production of newsprint (16 percent of consumption) is off 1 percent in the United States and 3 percent in Canada. Shipments of uncoated papers (14 percent of consumption) are down 0.2 percent and new orders off 2.9 percent. Shipments of coated paper (10 percent of consumption) are down 5 percent and new orders down 7.6 percent. Domestic containerboard (28 percent of consumption) is up 0.2 percent. These four grades represent 68 percent of total paper-paperboard consumption. Tissue and bleached paperboard are firmly up this year.

Industry shipments for 1989 to date are at a $130.4 billion annual rate, up 1.7 percent from the 1988 period. Shipments were up 7.5 percent for 1988. A 2 percent overall industry shipment increase is likely this year and again in 1990. The pricing environment is softening. Newsprint prices are down 10 percent from 1988. Discounts are evident in lightweight coated papers. Attempted price increases failed for linerboard and some uncoated papers. Higher dollar exchange rates have stalled increases in dollar-priced market pulp, which is the largest single export product and the underpinning of downstream paper prices. Reported export linerboard realizations at $379 per ton have retreated back to early-1988 levels; they are off 4 percent from mid-1988 highs, and may be 2 percent below average domestic prices. Local currency linerboard prices in Europe are the equivalent of $40 per metric ton below U.S. landed export list prices. Average lumber prices for the south and west at $230 per thousand board feet are identical to the 1988 price average. Plywood prices are off 2 percent. Lower interest rates may generate improved 1990 housing activity, but for seasonal reasons 1989 activity will remain at recent rates. Overall, average industry prices for primary and converted products may show a small year-over-year increase in 1989 relative to 1988. There are minimal prospects for 1990 price advances.

Labor costs this year are up at a 2.5-3.0 percent rate as compared to a 2 percent increase in 1988. Output per man-hour is up 0.3 percent this year, whereas the 1988 increase was 3.4 percent. Pulpwood costs in the south are up about 2.9 percent and will probably average up 10 percent in the western states. Chemical and energy cost increases are estimated at 5 percent this year.

Industry profit margins are already narrowing. Industry net profits averaged 7.5 percent of sales for 1988 with the 1988 final quarter at 7.1 percent. It is likely that 1989 net margins will be close to 7.0 percent of sales and somewhat lower in 1990. A typical mid-sized paper-paperboard company with a relatively large exposure to primary grades generated 1988 net margins at 9.5 percent, followed by 9.4-9.5 percent in the 1989 first quarter and will be at 8.8-9.0 percent for the balance of this year.

The 1988 average earnings per share increase was 66 percent. A 15-20 percent average rise was recorded in the 1989 first quarter and Goldman Sachs's second quarter forecast is for a 9 percent increase. Second half 1989 gains will average 0.5 percent and a 10 percent average decline is forecast for 1990. Five companies in a 22-company universe reported first quarter earnings per share declines and this number will climb for the remainder of the year. Less than five companies are expected to report 1990 earnings increases and these include consumer-related companies and a single instance of a major common stock repurchase program.

Peaking Profit Margins in the Chemicals Industry

Theodore S. Semegran

Lack of U.S. export strength is causing an earlier end to the cycle of earnings and profits than we at Shearson previously expected. In our third quarter 1988 report, we concluded that the cycle would not peak out before the end of 1989 and possibly past 1990 as well! That is no longer the outlook.

Early this year we were forced to address a new issue: a modest slowing of export growth and in many cases lower export volumes. Last year, any extra pound of product went to the export market. In 1989, that has not occurred. The reason is a drop in mainland China's demand and an economic malaise in South America, the two most important regions for U.S. commodity chemicals and plastics exports.

Will the strong 1988 export market return? Will the U.S. economy be ebullient enough to overcome the export slowdown? No, not at this time, even if China's chemical demands were growing at 10 percent plus. (The current turmoil there is also a modest factor.) Unfortunately, the Chinese government wants to limit growth to small gains to rein in inflation. Also, any return of strong economic growth to Argentina, Brazil, Mexico, and Venezuela is even more questionable.

The Economic Scenario Is Crucial

The most elusive factor in predicting the path of earnings remains the pace of the economy. We continue to assume 2 percent to 3 percent growth in 1989 and slightly less for 1990. However, most of the strong gains are forecast to occur in early 1989 (that appears true for domestic chemical activity) and

late 1990, with only 1-plus percent growth forecast for each quarter from the third quarter of this year through the first quarter of 1990.

With that economic backdrop, only a significant chemical plant overbuilding, possibly by mid- to late 1991, could cause a significant drop (25-30 percent) in earnings. However, since we know the capacity additions for 1990-91 already, the economy is still the key issue. Even by 1991, only a few chemical product operating rates, such as those for styrene monomer, polypropylene, acrylic acid, MMA, and possibly ethylene and polyethylenes, should decline, to the mid-80 to mid-90 percent range. We think declining operating rates would not occur with all chemicals. It still would take a product-by-product analysis to find products with spare capacity; most would probably not have any. However, with a more dire economic forecast, such as the deep recessions of 1981-82, earnings could drop even more, say 35 percent-50 percent.

The most positive scenario for the U.S. chemical industry would be continued weak U.S. currency (under 2.0 DM per dollar) and limited oil price increases, if any. The dollar appeared to be cycling within a 1.70-1.90 DM range until late May. Then it jumped to almost 2.0 DM. Any drop in interest rates will bring it down at least to the high end of that range. Oil prices, to our chagrin, have once again moved up sharply, to the $18-$21 per barrel area versus the $13-$14 zone they occupied six to eight months ago. However, it is well to keep in mind that $2-$3 per barrel price changes in oil have only a $0.007-$0.010 per pound cost impact. With chemical and plastic prices now averaging 40-50¢, a 1¢ per pound cost change is not very significant. In 1986, when chemical and plastic prices averaged 20-25¢ per pound, the story was different.

One of our principal concerns now, as it was in early 1986, 1987, and even 1988, is the possibility of a serious U.S. recession. We currently assign it a very low probability. Consumer durable and nondurable growth rates, however, were very low in 1988 and are likely to be even lower in 1989 and 1990. We are forecasting 1989 domestic auto sales of about 7.1 million units, or about 5 percent below 1988's 7.4 million level. Auto sales were 7.1 million in 1987 and 8.2 million in 1986. New housing starts in 1989 and 1990 are expected to be down about 100,000 units and 70,000 units, respectively, to 1.38 and 1.31 million. Existing home sales are likely to decline a bit, at 3.2-3.3 million units versus 3.6-3.7 million in 1988. This implies lower OEM demand growth in 1989 for products such as carpeting, appliances, plastic pipe, wiring, and so forth. There may be considerably more maintenance/additions/improvements in housing, but fewer new units.

Theodore S. Semegran
"Key factor: lack of expert strength."

While we expect to achieve some overall durable consumption growth in 1989, it will likely only be in the 0-1 percent area, not 4.8 percent as in 1988, 1.9 percent as in 1987, or 4.2 percent as in 1986. What we are still counting on for increased chemical demand in this area is reduced durable goods imports and more domestically produced consumer products to offset declines in durable and nondurable consumer demand. We also expect small declines again in imports of select textiles/apparel, electronic products, and perhaps even autos.

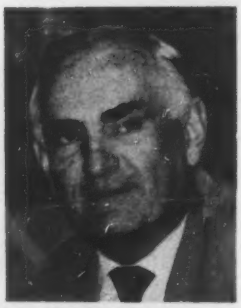
We are also concerned that the forecast buildup in Far Eastern chemical production capacity over the 1987->2 period could choke off U.S. exports by 1991-92. Far Eastern chemical construction activity is two or three times greater than in the United States. In addition, Far Eastern economies are growing 5 percent-10 percent per year.

The favorable news is that a major market, mainland China, still uses little plastics and chemicals (possibly 1-2 percent of U.S. usage). For example, U.S. per capita plastics use is about 200 pounds per person versus only four pounds per capita in China. Until recently, we have been only mildly concerned about potential Mideast and European petrochemical capacity additions. But the many Canadian, Korean, and Taiwanese additions announced could be troublesome since they are being built almost exclusively for export markets.

Oil Industry Profit Outlook

Dillard Spriggs

Recently, the oil industry has been experiencing something that has seldom characterized its operations in the past: a combination of rising profits from the downstream refining and marketing business, at a time when producing earnings are improved from better crude oil prices. Downstream earnings have historically been limited by chronic excesses in refining capacity, both in the United States and the rest of the world. But the overhang began to be trimmed in the early 1980s when many refining units were scrapped and marketing regions were consolidated as companies molded their operations to service the most populated cities and towns, thereby reducing distribution costs.



Dillard Spriggs
"Having its cake and eating it too."

It has now been nearly 15 years since a grass roots refinery was erected in the United States. Nor is one apt to be, for at least two reasons. One is the inability to obtain requisite permission from local and state authorities. The other is concern on the part of most oil executives and planners that demand for gasoline—now growing 1 to 2 percent annually—could cease to grow as a result of increased federal and state taxes and because or rising federal standards on auto and truck efficiency.

The upshot is that refined product demand, particularly for gasoline, is being met by "capacity creep." Refiners add to their conversion capacity downstream from the straight crude-oil processing units by bits and pieces to make more gasoline or other products. All the while, they are screening their marketing facilities for new economies by weeding out the least profitable operations. Thus, capacity creep can satisfy their operating and profit goals. The final goal is profit growth, not volume growth.

Today's oil market in the United States is gasoline driven. The average retail price of all grades of gasoline—unleaded and leaded—is now over $1.10 per gallon, up more than 15 cents from spring 1988. Starting in spring 1989, gasoline led and supported an advancing price for crude oil.

As everyone knows, however, crude-oil pricing is set less in the United States than it is in the Persian Gulf and by the OPEC producers group. Having coalesced in November 1988 on a new quota program, OPEC set in motion a solid increase in world crude oil prices. Instead of $15 a barrel or less in 1988, oil prices increased to more than $20 per barrel early in the second quarter of 1989.

And world oil demand plus increasing import needs in the United States, where production is falling, easily absorbed OPEC's quotas and then some. By May 1989 OPEC production rose above 21 million barrels per day—or 2.5 million barrels per day higher than the 18.5 million-barrels-per-day quota. OPEC was having its cake and eating it, too—overproducing at a good price.

There can be too much of a good thing, and at the recent meeting of OPEC oil ministers at the beginning of June quarrels over what should be accomplished were not settled. Kuwait telegraphed its position well before the meeting, saying it had to have a steep increase in its quota not just a proportionate share of any increase in the over-all quota. It held to that position throughout the meeting and only signed the new agreement raising the total quota to 19.5 million barrels per day with the reservation that it would not accept its designated quota of 1,093,000 barrels per day, a paltry 56,000 barrels per day higher than its previous allotment. The Kuwait minister indicated after the meeting that his country might hold production to around 1,350,000 barrels per day—well below the 1.8 million barrels per day or so that it produced in April and May.

It now appears that Kuwait is just one of several countries that will not necessarily hold production at the quota assigned to it at the June meeting. This interpretation has affected prices trading with both product prices and crude oil prices in the United States and Europe retreating across a broad front.

Various interpretations have been assigned to the reasons behind Kuwait's obstinate stance. The one that seems most compeling is the awareness that neighboring Iraq is nearing the time when its capacity to export will reach 5 million barrels per day or more. And Iran is also likely to be able to raise its exports by measurable quantities in a year or so. Kuwait, with current capacity of around 2.5 million barrels per day and the possibility of lifting it to 3.5 million barrels per day, simply does not want to be left at the starting gate. It does not want to learn some time in the future that it will have to fight tooth and nail for every barrel of increased quota.

The OPEC ministers provided themselves with something of a safety net by scheduling another meeting for September. In the event that the summer witnesses a sharp drop in the crude oil price, they can assemble again and try to put a finger in the dike.

There now appears to be a good deal of oil in the world system, either in inventory or at sea moving to the market or being contracted for lifting in the next 30 to 45 days. It is also possible that demand growth will ease perceptibly before the end of 1989. The forecast of the International Energy Agency is based on growth in world demand ranging between 2.5 and 3.8 percent in each of the first three quarters of 1989, followed by a slowing to 1.1 percent in the fourth quarter. Fourth quarter 1988 demand was inflated by certain non-recurring factors in Japan and southern Europe and the estimate of Petroleum Analysis, Ltd. is that the increase in world demand during 1989's final quarter will be nominal.

Profits of oil companies cannot escape the near constant ratcheting to and fro of market influences and gyrations of OPEC actions. The immediate outlook for profits is very strong, as the best of both ebullient downstream profits and advanced crude oil quotations combine to generate what may well be records. The third quarter is not likely to reveal quite as great results as the second. Thereafter, the workings of OPEC will be dominant and if one were to look over an eighteen-month period, volatility in crude oil prices is likely to be repeated on the same sort of up-and-down cycles that have characterized the past few years.

These cycles have been within a broad range of around $12.00 on the downside and $20.00 on the upside. Within this sort of environment, the abiliy of downstream operators to achieve more dependable and remunerative profits than historically seems assured for the reasons cited earlier. There is one other important influence that until very recently has not provided a strong support to oil company profits but will in the future. That is natural gas. The surplus of gas in the United States is dwindling. Prices are strengthening, not on a straight line, but from winter to winter they are trending up and that will continue. And longer term, the yearning for a cleaner environment will benefit natural gas over both coal and oil.

Automobile Industry Profits, 1989-1980

Maryann N. Keller

The first quarter of 1989 marked record profits for each of the domestic automakers as industry earnings reached $3.5 billion, up from $2.9 billion in 1988. The record-breaking performance was due to higher vehicle production in North America and overseas; a rich mix of vehicles, including a higher percentage of trucks that carry greater profit margins than cars; and, for General Motors and Chrysler, the beneficial impact of measures to lower costs.

Maryann N. Keller
"The end of favorable profits comparisions."

The second quarter, however, will mark the end of favorable comparisons for the industry as slower sales, rising marketing expenses, and higher variable costs not recovered through pricing will depress earnings. Although the foreign operations of General Motors and Ford remain very strong, the strength of the dollar will result in reduced foreign income due to translation effects of a falling German mark and British pound. Compounding these effects is the fact that all three automakers are increasing capital spending to upgrade models and meet the challenge of imports, especially in full-size and luxury models.

Over the past six years a record 80 million vehicles were purchased in the longest postwar economic expansion. Import competition had little effect on pricing even though market share erosion for domestic automakers continued, albeit at a slower pace than in the early 1980s. Initially quotas on Japanese cars and then the rise in the value of the yen enabled Detroit to raise prices and expand margins as prices of Japanese cars escalated. Cost pressures were moderate during this period and offset by pricing. The industry was unfettered by new government regulations and, in fact, some regulations, notably bumper and fuel economy standards, were rolled back under the Reagan administration. Following the second energy crisis consumers' tastes shifted back to large cars and lightweight trucks, both of which are more profitable than small cars. At the same time, Europe enjoyed record sales, which produced record earnings overseas for General Motors and

United States Cars and Trucks
(millions of units)

	1986	% Chg.	1987	% Chg.	1988	% Chg.	1989 est.	% Chg.
Cars								
Total sales	11.5	4%	10.3	-10%	10.6	4%	9.8	- 8%
Less imports	3.2	14%	3.2	- 1%	3.1	- 3%	2.9	- 6%
Equals domestic sales	8.2	0%	7.1	-14%	7.5	7%	6.9	- 9%
Memo: foreign auto production in U.S.	0.6	34%	0.7	19%	0.8	19%	1.2	45%
Trucks								
Total sales	4.8	3%	4.9	2%	5.1	4%	4.8	- 6%
Less imports	0.9	20%	0.8	-11%	0.6	-27%	0.5	-25%
Equals domestic sales	3.9	0%	4.1	5%	4.5	10%	4.4	- 3%

Ford. It is hard to imagine a more benign environment for the domestic industry.

Auto demand will drop to about 9.8 million units this year from 10.6 million in 1988. It could fall again to 9.5 million units next year as a result of saturation of demand and a high consumer debt burden. Likewise truck volume could decline to 4.8 million units from 5.1 million last year. Pressure to support or increase market share will intensify. The average expenditure on a new car has risen 95 percent since 1980 compared to 50 percent for median household income. Lenders extended average car loan maturity to 56 months from 45 months in 1980. Recent data support the notion that customers will not return to the marketplace until they have paid off their old loan so that the holding period for a car bought today is more than five years compared to just three years a decade ago. Declining residual values of cars have also forced owners into this pattern since the borrower has no equity in the vehicle until the fourth year of the typical loan. It is, therefore, not surprising that consumers, loaded with debt, have decided to buy vehicles at a level that reflects replacement demand.

Compounding the problem of lower sales is the explosion in the supply of automobiles that is intensifying the competitive battle for market share. Automakers believe that with new Japanese transplant capacity of some 2.3 million units a year added to normal imports and domestic capacity, the oversupply of cars is between three and five million units. This unprecedented excess capacity is already being translated into a brutal battle for share. At the retail level this has triggered promotions and rebates, which have lost their effectiveness in boosting total sales, but are still useful in luring buyers to a particular brand. Even the Japanese and European luxury carmakers have been forced into rebates. A second, and more insidious element of the battle for market share, is taking place in the fleet market, particularly among daily rental accounts.

· During the past two years auto companies have invested in or acquired the five major daily car rental firms. These companies represent outlets for surplus capacity, as automakers sell them cars with guaranteed repurchase agreements at specified prices four months or so from the original transaction. The vehicles are then taken back and auctioned off to dealers. The entire transaction has been justified on the basis that the cars get exposure, which might prompt some people to buy the model they rent, and that the transation covers variable costs with a small contribution to fixed costs—an important consideration in the high fixed cost world of automaking. Last year about 20 percent of sales were accounted for by fleet customers. This year the proportion will rise, and these sales are less profitable than retail transactions.

Foreign brand sales, imports, and transplants numbered 3.3 million or 31.3 percent of sales in 1988, and are estimated at 3.1 million or 31.5 percent in 1989, 3.1 million or 33 percent of sales in 1990.

In addition to these competitive considerations, automakers are confronting a period of more intense government regulation. The Bush administration has signaled the beginning of more active government intervention over safety, emissions, and fuel economy standards. The light-weight truck, in particular, will be brought into compliance with the standards that exist for passenger cars. In 1990, cars will have to comply with passive-restraint regulation. Ford and Chrysler have elected to install airbags at a cost of $350 or so per car; GM opted for the cheaper active belt. Raising prices to compensate for these and other mandated items will be difficult and perhaps impossible given the reluctance of lenders to extend auto loans beyond 60 months.

In 1989, industry profits will decline 13.6 percent to $9.2 billion from approximately $11 billion in 1988. The tentative outlook for 1990 is for another drop in income to approximately $8.0 billion, as costs and competitive pressures build and vehicle demand remains weak. Automakers are redoubling their efforts to reduce costs, but in the short term, expenses will rise and pricing will be insufficient to recoup them. The competitive climate is likely to worsen over the next two years as Japanese transplant factories reach full production and expand their presence into large cars and light-weight trucks, the most profitable sectors of the business.

Capital Goods Profits, 1989-1990

Adrian Dillon

Recent trends and prospects for profits of U.S. capital goods companies are quite favorable, though you would never get that impression by looking at Wall Street. In 1987, sales of U.S. capital goods manufacturers rose 9 percent and net income surged 80 percent; last year, sales rose 14 percent and net income rose another 25 percent. Today the industry's return on equity equals that of the S&P 400 and, during 1989 at least, fixed investment is generally acknowledged to be the strongest sector of economic growth, not only in the United States but worldwide. We expect sales of U.S. capital goods producers to rise nearly 13 percent this year and net income to rise over 15 percent. Assuming a "soft landing" for the economy in 1990, sales should be up another 9.5 percent and profits up an additional 10-15 percent.

Yet, as the chart shows, on Wall Street the relative valuation of capital goods stocks is at the lowest level in the entire post-WWII period! Today, capital goods stocks generally are valued at a 30 percent *discount* to consumer goods stocks, compared to a 30-40 percent *premium* during the late-1970s and a 40-year average *premium* of 20 percent to the overall market.

What's going on? Perhaps Wall Street does not buy a "soft landing" for the economy, although with the Dow above 2500 and long bonds at 8 percent, it seems that the market has bought this felicitous scenario in spades. Instead, I think that there are structural reasons for some of the relative decline in the value of capital goods stocks, as the table below suggests.

U.S. Capital Goods Companies
Operating Profit Margins
%

	1974-1979	*1980-1985*	*1986*	*1987*	*1988*	*1989e*
Information Processing	20.3%	16.7%	11.3%	12.3%	12.6%	13.0%
Industrial	10.7	11.1	6.5	7.8	9.8	10.2
Transportation	7.9	4.7	5.0	5.0	5.8	6.0
Other	12.8	13.6	4.6	6.6	9.4	11.0
Total Capital Goods	13.4%	11.5%	8.4%	9.7%	10.6%	10.9%

Using operating margins as the best available measure of economic profits, it is clear that there has been a structural deterioration in the fundamental profitability of the capital goods industry: Overall margins today, at about 11 percent, are still 2½ percentage points below the 13.4 percent average of 1974-1979 and, indeed, more than a half point below the average of the first half of the 1980s.

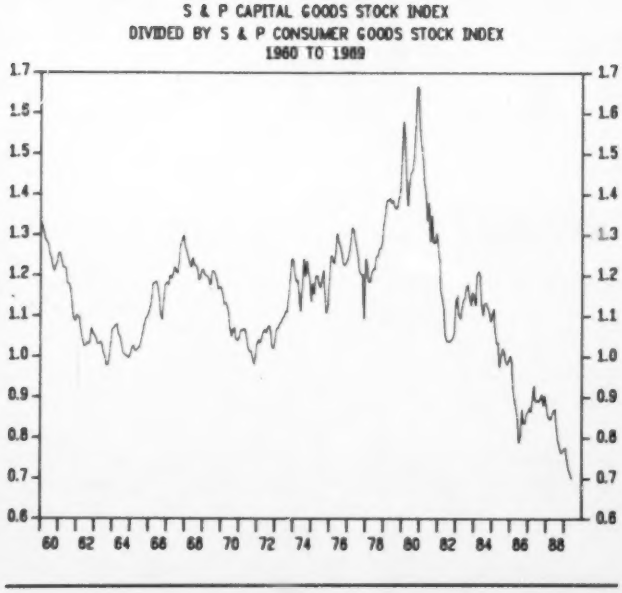
There are two reasons for the structural deterioration in the industry's basic profitability. Taking a long-term perspective first, part of the decline in industry profit margins was inevitable. After World War II the United States stood preeminent

Adrian Dillon
"Surprisingly good times ahead."

in all economic sectors, but none more so than capital goods; even through most of the 1970s the United States was by far the leading producer, exporter, and consumer of capital goods, with worldwide leadership across all categories of equipment—particularly high-tech information processing equipment. Today, the United States no longer stands alone, even in capital goods; while the export share of U.S. manufacturers shipments of capital goods is undiminished at nearly 40 percent, the import share of U.S. capital goods purchases has tripled in the past decade to over 35 percent today.

The relative loss of U.S. preeminence in capital goods is most clearly seen in the margin trend for information processing companies—a broad category of "high-tech" capital goods that includes computers, telecommunications, instrumentation and software, and today represents nearly 50 percent of total industry sales. During the 1960s and 1970s, the clear technological lead U.S. "high-tech" companies enjoyed allowed them to achieve operating margins that were double other categories of capital goods and the S&P 400 generally. As the table suggests, the competitive superiority of U.S. manufacturers is no longer clear cut: operating margins for information processing equipment companies last year were only 60 percent of their 1970s average and only 2½ points higher than margins of other capital goods companies.

The profitability of those other categories of capital goods companies over the past quarter century show similar but much less pronounced trends: industrial equipment companies (27 percent of industry sales) today have operating margins about 1 percentage point below the experience of the 1970s and early-1980s at about 10 percent. Transportation equipment companies (17 percent of industry sales) suffered through the



depressing impact of the deregulation of the airline, railroad, and trucking industries, as well as the early-1980s recessions; today profit margins are still two points below the 1970s average but are well above the prevailing levels of the 1980s.

Outlook for 1989-1990

The relative loss of U.S. competitive advantage and the development of a truly global capital goods marketplace was accelerated and compounded by the gross overvaluation of the U.S. dollar during the mid-1980s. As the table documents, operating margins of U.S. companies were decimated by the "deindustrialization" of U.S. manufacturing that resulted in very weak capital spending during 1985-1986, combined with a new flood of low-cost, high-quality imported capital goods that resulted from the dollar's astonishing mid-decade strength.

Today, however, is a different story. The U.S. dollar, though up from its recent lows, is still down 50 percent from its peaks versus major international competitors in the global capital goods market. As a consequence, U.S. capital goods orders and shipments have been surging. Last year, U.S. purchases of capital equipment rose 13 percent, and U.S. exports of capital goods jumped nearly one third! As a result, the trade *surplus* in capital goods more than doubled to $22 billion. With demand up and competitiveness "restored" by the lower dollar, operating margins rose across the board to 10.6 percent, 0.2 percentage *above* the average for the S&P 400.

This year, despite predictions to the contrary, U.S. capital spending plans have been repeatedly revised up, with the latest survey suggesting a further 10 percent rise in capital spending this year. Eaton expects shipments to rise about 13 percent this year and operating margins to improve modestly again, to about 11 percent; thus, operating profits should be up over 15 percent during 1989. Next year we expect the U.S. economy to achieve a "soft landing" with about 2½ percent real GNP growth and real capital spending up about 5 percent. With the dollar remaining at or below current levels and expansion outside the U.S. continuing at a rate above domestic growth, U.S. manufacturers should continue to benefit from their position as the single largest category of both export and import trade. Sales and margins will also benefit from a new product cycle in the computer industry as well as a surge in deliveries of commercial aircraft next year. Overall, we expect 1990 sales to be up about 9.5 percent and margins to improve slightly to 11.3 percent, producing roughly a 13.5 percent rise in operating profits.

In short, there are two important trends influencing the fundamental profitability of the U.S. capital goods industry. The secular trend toward a global capital goods market is probably irreversible: The U.S. will never again have the kind of technological and market lead that it maintained during the 1950s, 1960s, and 1970s. In particular, information processing equipment manufacturers will not be able to command the kind of margins they enjoyed during most of the past four decades; they will probably continue to converge toward the capital goods industry average. As such, the industry is very unlikely to see the kind of premium in its stock price that was typical during the post-WWII period.

But the current severe discounting of capital goods stocks also seems overdone. Just as the industry suffered disproportionately during the "deindustrialization" of the mid-1980s, so too is it now benefitting disproportionately from the much lower dollar, the turnaround in capital goods trade, and the global capital spending boom. We expect surprisingly good times for U.S. manufacturers and shareholders in the years immediately ahead.

Airline Profitability

George W. James

The U.S. airlines have experienced an abysmal profit record, both under regulation and deregulation. Generally, they have averaged only a fraction of the U.S. industry profit margin record, showing, for example, only about 1 percent net profit margin over the past ten years.

Prior to airline deregulation in 1978, below normal profit margins were acceptable, since the airlines were essentially franchised and no one ever failed or went out of business. However, over the past ten years, considerable volatility has occurred with many new entrants and over 200 airlines going out of business (mergers, acquisitions, or bankruptcy). One can only conclude that investors stayed with the industry anticipating better times to come and trying to bet on a winner, or a survivor. Those better times have begun to arrive. The industry set record operating profits in 1988 of $2.8 billion and produced a net profit of $1.4 billion. It is expected to improve on this record in 1989.

What has happened to produce this turnaround and how long can it be expected to last? Primarily, the good results, still only about one half the U.S. industry profit margin performance, result from a shakedown of the highly competitive airline environment in the first seven years of deregulation. Eight large companies now control over 94 percent of the market and three of those are relatively weak, Eastern, Pan Am, and TWA. The eight carriers hold significant hub/spoke operations at nearly all major airports throughout the United States controlling traffic from its origin, say, in a relatively small or thinly populated area through major cities to an ultimate second small city destination on the other side of the country. Their passengers generally are tied to a carrier through such arrangements as the frequent flyer programs, which, from the passenger's standpoint, represent an investment with an anticipated return (a free trip). These eight carriers also own, or have a share of ownership, in the five principal computerized reservations systems through which flow the sale and distribution of nearly all airline tickets.

Thus, the market position of the larger five or six carriers is now established and the profitability prospect for the industry and for these carries is very promising over the next several years.

This promising prospect comes not only from the oligopoly structure of the airlines but also through smarter pricing moves. Perhaps the most significant profitability move by the surviving U.S. airlines has come through sophisticated yield (pricing) management. In this area, it is possible for an airline to increase the average price it receives while holding the passenger fare levels constant or even dropping. The method simply involves looking at advanced bookings on a particular flight and making frequent changes in the number of seats allocated for various fares as the date of departure approaches.

George W. James
"Promising prospects through smarter pricing."

This method permits an airline to avoid selling a seat at discount if it is likely to go at full fare. Or if the full-fare seats are not selling, it allows more discount seats to be offered to assure that near-maximum revenue is realized for the flight. The airlines are improving on this technique daily and it offers the prospect of significant profit returns in the future.

Smarter pricing comes just in time. Fuel costs are beginning to rise again, labor costs, which recently leveled and, in part turned down, are now starting to rise once more, and a record level of $96 billion of orders and options for new equipment will require increased profitability.

There is one major caveat to the prospect of improving profitability. The airlines must find a way to persuade passengers, the public, and the Congress that airlines are entitled to price increases that are not out of line with the general inflation level, as long as profit margins are below normal and productivity is above normal, as has been the case. From 1978 through 1988, the average yield of the industry rose only one-half as fast as the consumer price index. In 1988, however, yields rose about two percentage points above the general inflation level. This brought on media inquiries, congressional hearings, and angry congressmen and passengers. Failure to meet this uprising will possibly result in forms of government re-regulation that inevitably bring regulatory lag in price changes versus costs and then result in declining profit margins.

Health Care

David J. Lothson

Paine Webber estimates that total spending on health care reached $555 billion in 1988, up approximately 11 percent from the half trillion dollar level of the preceding year. Despite an anticipated slowdown in overall economic growth both in 1989 and 1989 we project a continuation of 11 percent, with health care spending reaching $615 billion in 1989 and climbing to $684 billion in 1990 (see table). Health care spending will consume roughly 12 percent of GNP in 1990 versus 9.2 percent in 1980, up from 6.0 percent in 1965. Without new programs or changes in existing ones, the United States can expect to pay 19 percent of GNP on health care by the end of the century and 28 percent by 2010.

David J. Lothson
"Without insurance, becoming seriously ill is a nightmare."

There are several factors that have conspired to produce health care's record of rapid growth. Among the most frequently cited are the aging of the U.S. population and the advance in medical technology. People 65 and older consume health care resources at four times the national rate, while the new drugs, devices, and procedures are thought to add incrementally to the cost of the overall health care bill. Drugs and medical supplies consumed outside the hospital represent only 6.5 percent of what Americans pay for health care, and no more than twice that percentage when all the drugs and supplies used in hospitals are included. The big costs of the health care bill, consistently two-thirds of spending over the last 25 years, are for hospitals and doctors. The rates of growth in these expenditures are far more a function of the nature of the reimbursement systems, how Americans pay for health care, than demographics or technology.

Spending on housing, autos, and other consumer items is critically dependent upon the overall economic climate. Cancer, heart attacks, bleeding ulcers, and AIDS are not. Some Americans, the elderly and the indigent, have been given health care coverage through the entitlement programs of Medicare and Medicaid. For most of those who are employed and their dependents, health care is a benefit, although in light of the rapid increases in co-payment and deductible provisions, an exceedingly less generous one. For those estimated 37 million Americans who have no health insurance, becoming seriously ill is a nightmare. The deceleration in the rate of health care spending enjoyed in the middle 1980s and attributable to Medicare's DRG Program was at best temporary, and is increasingly viewed as the reason for the 20 percent plus annual increases paid by private employers for health care costs. Providers, doctors, and hospitals, have learned to shift the cost of their services to non-government payors, thus preserving the infrastructure and its costs.

In the 1990s, America must address its health care system problems. Nationalization of health care, at least hospital and physician care, has been the route taken by virtually every other developed nation since World War II, and most have been successful. The performance of several U.S. government agencies coupled with reports of delays for surgery and outright rationing of care, such as in England, have made Americans understandably skeptical about consigning their health care to a government that purchases $600 hammers, presided over the savings & loan debacle, and watches congressional leaders resign in the face of ethical impropriety. If history repeats,

U.S. Health Care Spending
(Billions of Dollars)

	1980	1987	1988E	1989E	1990E
Personal Health Care Expenditures:	$101.6	$194.7	$217.0	$243.0	$273.0
Hospital costs	46.8	102.7	115.0	127.0	142.5
Physician services	20.4	40.6	46.0	51.0	56.5
Nursing home costs	18.8	34.0	38.0	42.0	46.5
Drug and medical supplies	15.4	32.8	36.0	41.0	45.0
Dental care	16.7	37.9	41.5	45.5	50.0
Administration and insurance costs	10.6	25.9	27.5	29.5	32.0
Public health, research & const.	19.2	31.8	34.0	36.0	38.5
Total	249.5	500.3	555.0	615.0	684.0

Source: Health Care Financing Administration and Paine Webber estimates.
(E) Estimates.

crisis will again prove the catalyst. Should the increasing consensus of an economic soft landing prove inaccurate or if the current FASB proposal to require corporations to recognize and reserve for retiree health care benefits be adopted, a national health care program could be adopted as early as 1992. At the latest, nationalization by the mid-1990s seems highly certain.

How would a national health care system be structured in the United States and what would its implications be? Under a one-buyer system uniform hospital and physician reimbursement would become the norm. The cost of a hernia repair, a surgeon's services, a pacemaker, CAT Scanner, or thiazide diuretic would no longer be a function of what the seller could charge, but rather what the buyer will pay. We need not buy into the "complete package" of cradle-to-grave care, but a system providing uniform access to hospital and physician care would prove a logical starting point. The impact of nationalization on what by mid-1993 will be a trillion dollar part of the U.S. economy is likely to be without precedent in this society.

Banking Profits in 1990

Nevins D. Baxter

To include, as we at BEI Golembe do, that bank profits will be up 8 to 10 percent next year, and that thrift earnings could increase by 15 percent or more, is akin to saying that the average weight of an ant and an elephant is about two tons, but that a hippo and an elephant average out to a somewhat higher number. To my mind the safest statement about the 1990 outlook is that there will be widely different results among companies and regions—a trend that has characterized banking in recent years.

Our conclusions about *average* profit growth assume some further decline in market interest rates over the summer with generally flat rates next year. (I should caution that this is not a rate forecast—a function that I quickly delegate to others—but rather what seems to us to be a consensus view.) It is consistent with what has been fondly termed the "soft landing" scenario—moderate inflation in the 5 percent range, and somewhat slowed but nevertheless continued loan growth. While bank earnings *on average* will not be substantially impacted by the rate environment, thrift earnings will continue to swing widely over the rate cycle. If the rate assumptions pan out, thrifts should experience strong earnings—perhaps comparable to 1986.

Regional differences in overall profitability will continue largely as the result of credit quality—particularly in real estate but also in energy and agriculture. Regional differences in loan growth and interest spreads will be less significant, but resolution of the thrift crisis should result in lower deposit pricing and better margins, particularly in those areas of the country, such as Texas, where troubled institutions have had to pay up for their funding. In general, though the southwest economy is expected to show slow improvement, there will be intense competition for whatever loan growth exists among a variety of new players. Real estate problems will become increasingly significant in the northeast—particularly in metropolitan Boston and New York, and perhaps to a lesser extent in Florida. The rust belt banks should continue to do well, but recent increases in the dollar, if sustained, will be a negative factor.

Among individual companies, significant variation in performance, and in top management turnover historically uncharacteristic of the industry, will continue. The Bank of America story is well known to all—losses, management changes, survival of a hostile takeover attempt, restructuring and return to profitability as a smaller west-coast-oriented bank. First Fidelity was known as an outstanding performer among super regionals with a strong New Jersey and eastern Pennsylvania banking presence. In the fourth quarter 1988, loan problems relating to a London branch and certain large real estate projects were discovered resulting in a $235 million addition to loan loss reserve. Toledo-based Trustcorp was a rapidly expanding $6-million company whose shareholders had experienced 37 years of consecutive dividend increases. Because of loan losses in the lead bank relating in large part to redevelopment loans in downtown Toledo, income declined from $48 million in 1987 to $1 million in 1988. Ensuing shareholder legislation has put the company on the sales block. Both First Fidelity and Trustcorp have replaced their senior executives.

Nevins D. Baxter
"Top management turnover will continue."

Without predicting identities, there will be other such cases in 1990—hopefully, isolated and nonrecurring. Beyond this, companies who have been successful in controlling net noninterest expense (in the environment of of narrowing spreads) will continue to be the winners. Finally, with generally lower levels of liquidity in the banking system, companies with the ability to fund loan growth opportunities should do well.

Barring a major economic or political shock, we believe financial institution stocks will outperform the market. This fact, the resolution of the thrift crisis, and the digestion of the last wave of acquisitions, should result in renewed merger-and-acquisition activity—big interstate deals and bank holding company acquisition of thrifts. Some short-run earnings dilution may result among the acquirors, with differing long-term impacts, reflecting the success of the acquisition and implementation strategies.